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The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments

Eric J. Byrne*

I. Introduction

Under the tax benefit rule a taxpayer who recovers an amount deducted in a prior year must report that amount as income in the year of recovery to the extent the prior deduction resulted in a tax benefit.¹ Two recent cases constitute important developments in the application of this rule. In *Tennessee-Carolina Transportation, Inc. v. Commissioner*,² the Sixth Circuit, affirming the Tax Court, extended the tax benefit rule to liquidating distributions of previously expensed assets. A central question in that case was whether a corporation has "recovered" anything when it simply distributes an asset in liquidation. In *Putoma Corp. v. Commissioner*,³ the Fifth Circuit, affirming the Tax Court, declined to apply the tax benefit rule to a corporation which had been forgiven interest indebtedness by its shareholders after the corporation had deducted that interest as an accrual basis taxpayer in an earlier year. The court held that the tax benefit rule was overruled by sections 102 and 118 of the Internal Revenue Code (the Code),⁴ which grant income nonrecognition to gifts and contributions to capital respectively.

This article takes the position that *Tennessee-Carolina* represents a proper extension of the tax benefit rule, while *Putoma* represents a backward step inconsistent with the development of the rule in the corporate liquidation area. The article discusses, first, the rule's application in the corporate liquidation area, and second, the rule's application in the contribution to capital area.

II. Corporate Liquidations and the Tax Benefit Rule

Under Code sections 336 and 337, a liquidating corporation generally does not recognize gain or loss if it either sells its assets or distributes them to its shareholders. Section 336 provides that, except for the disposition of LIFO⁵ in-

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1 Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 401-02 (Ct. Cl. 1967); Estate of Munter v. Commissioner 63 T.C. 663, 671 (1975).

2 582 F.2d 378 (6th Cir. 1978), *aff'g* 65 T.C. 440 (1975), *cert. denied*, 440 U.S. 909 (1979).

3 601 F.2d 734 (5th Cir. 1979), *aff'g* 66 T.C. 652 (1976).

4 All statutory references, unless otherwise indicated, are to the Internal Revenue Code of 1954.

5 LIFO ("last-in, first-out") is a method for identifying the closing inventory at cost. Under I.R.C. § 472 a taxpayer may elect to use this method subject to approval of the Commissioner. Using LIFO, a taxpayer may treat the inventory at the close of the taxable year as consisting of first, those goods included in the opening inventory of the taxable year and second, those goods acquired during the year.

ventory and certain installment obligations under section 453,⁶ a corporation recognizes no gain or loss on the distribution of property in partial or complete liquidation. Section 336 was enacted as part of the 1954 Code and merely reflects the prior common law that a corporation cannot be deemed to realize a gain or loss on the mere distribution of an asset.⁷

Section 337 provides that if a corporation distributes all of its assets less assets retained to meet claims, in complete liquidation within twelve months following adoption of a plan of complete liquidation, the corporation shall recognize no gain or loss from the sale or exchange of its property within that twelve month period. Section 337(b) excludes from the definition of "property," and thus from the nonrecognition rule, sales of inventory other than bulk transfers and certain installment obligations. Like section 336, section 337(f) contains an exception for LIFO inventory. Unlike section 336, section 337 in no way reflected prior law. Before 1954, a corporation holding appreciated assets could liquidate in two ways. The corporation could sell its assets to a third party, distribute the proceeds to its shareholders, and be taxed on the gain realized from the sale. Alternatively, it could distribute the assets to the shareholders and escape taxation. However, depending on the formalities employed, a subsequent sale of distributed assets by shareholders could be attributed back to the corporation and the corporation would not escape taxation.⁸ Section 337 was enacted to avoid these formalistic distinctions and eliminate uncertainty.⁹

Thus, since 1954, there is generally only one taxable event involved in a distributing of liquidation assets. A corporation will generally escape tax on the appreciation of its distributed liquidation assets under either section 336 or section 337. However, the shareholders will generally be taxed on the difference between their basis in the stock and either the cash or the fair market value of the assets distributed to them in liquidation.¹⁰

Despite the literal applicability of the nonrecognition rules of sections 336 or 337 to a transaction, in two general areas courts have forced corporations to

6 Section 453 provides that income from the sale of property on the installment basis may be reported as the payments are received. Its purpose is to permit the spreading of income tax on the sale over the period of installment payments, rather than recognizing the full taxable gain before the full selling price has been received.

7 See S. REP. NO. 1622, 83d Cong., 2d Sess. 258 (1954); Treas. Reg. 111, § 29.22(a)-20 (1944); Gould v. Commissioner, 21 B.T.A. 824, 829 (1930).

I.R.C. § 311, which also came into being with the 1954 Code, provides that a corporation generally does not recognize gain or loss on the nonliquidating distribution of an asset. Section 311 like § 336 reflects prior common law. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 37 (1954); General Util's & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935).

8 See United States v. Cumberland Pub. Serv. Co. 338 U.S. 451 (1950); Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

9 See H.R. REP. NO. 1337, 83d Cong., 2d Sess. a106 (1954); Central Tablet Mfg. Co. v. United States, 417 U.S. 673, 682, 691 (1974). According to the doctrine of "anticipatory assignment of income," one who earns or otherwise creates the right to receive income will be taxed on that income even though he assigns the right to receive it to another before realizing the income. The underlying policy of the doctrine is to tax the assignor enjoying the benefit of the economic gain represented by his right to receive the income.

If a parent corporation possesses at least 80% of the combined voting power of all classes of a subsidiary's stock entitled to vote, and also owns at least 80% of the total number of shares of all other classes of the subsidiary's stock (except nonvoting stock which is limited and preferred as to dividends) then that subsidiary is referred to as an "eighty percent or greater subsidiary."

10 I.R.C. §§ 331, 1001(a)-(b). But see the nonrecognition rules for shareholders in certain elective one-month liquidations under § 333 and the nonrecognition rules for a parent corporation in the liquidation of an 80 percent or greater subsidiary under § 332.

recognize income in the course of liquidation under broad principles outside those sections. The first general area involves the distribution or sale by a corporation of rights to income. In such situations the courts have utilized two weapons in forcing recognition of income: the judicially created anticipatory assignment of income doctrine,¹¹ and the authority granted the Commissioner under section 446(b) to change a taxpayer's accounting method when the existing method does not clearly reflect income.¹²

The second general area involves application of the tax benefit rule. The rule is of judicial origin but has received indirect ratification in section 111, which deals with the exclusionary aspect of the rule.¹³ Section 111, originally enacted in 1942,¹⁴ provides that gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax or delinquency amount to the extent that these items did not result in a reduction of the taxpayer's tax. Section 111 was enacted to reverse judicial decisions holding that recovery of a previously deducted amount resulted in income despite the lack of a tax benefit to the taxpayer by reason of the deduction.¹⁵ Although the statute only specifies bad debts, prior taxes and delinquency amounts, the Supreme Court of the United States took a much broader view of the exclusionary aspect of the rule in *Dobson v. Commissioner*.¹⁶ Accordingly, the Regulations under section 111 provide that the rule of exclusion in the statute "applies equally with respect to all other losses, expenditures and accruals"¹⁷

In addition to these broad overriding principles compelling recognition, code sections 1245 and 1250 employ the tax benefit rule to override sections 336 and 337 in the case of depreciation deductions. Prior to the enactment of sections 1245 and 1250,¹⁸ net gains from sales of depreciable business property were generally afforded capital gains treatment pursuant to section 1231,¹⁹ and

11 *Storz v. Commissioner*, 583 F.2d 972 (8th Cir. 1978); *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973); *Idaho First Nat'l Bank v. United States*, 265 F.2d 6 (9th Cir. 1959); *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952); *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961).

12 *Commissioner v. Kuckenberger*, 309 F.2d 202 (9th Cir. 1962), *cert. denied*, 373 U.S. 909 (1963); *Idaho First Nat'l Bank v. United States*, 265 F.2d 6 (9th Cir. 1959); *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952); *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946); *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961).

13 *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 402 (Ct. Cl. 1967); *Estate of Munter v. Commissioner*, 63 T.C. 663, 671 (1975); *Bittker and Kanner, The Tax Benefit Rule*, 26 U.C.L.A. L. Rev. 265, 265-66 (1978).

14 The predecessor of I.R.C. § 111, section 22(b)(12) of the 1939 Code, was added to the Code by § 116 of the Revenue Act of 1942, ch. 668, 56 Stat. 812.

15 *Dobson v. Commissioner*, 320 U.S. 489, 506 (1943); Tye, *The Tax Benefit Doctrine Reexamined*, 3 TAX L. REV. 329-30 (1948); Note, 21 VAND. L. REV. 995, 999-1001 (1968).

16 320 U.S. 489, 506 (1943). The Supreme Court stated:

A specific statutory exception was necessary in bad debt cases only because the courts reversed the Tax Court and established as matter of law a "theoretically proper" rule which distorted the taxpayer's income. Congress would hardly expect the courts to repeat the same error in another class of cases, as we would do were we to affirm in this case.

Id.

17 Treas. Reg. § 1.111-1(a) (1956). The same regulation, however, removes from the general exclusionary rule "deductions with respect to depreciation, depletion, amortization, or amortizable bond provision."

18 I.R.C. § 1245 was added by the Revenue Act of 1962, Pub. L. No. 87-834, § 13(a)(1), 76 Stat. 1032. I.R.C. § 1250 was added by the Revenue Act of 1964, Pub. L. No. 88-272, tit. 2, § 231(a), 78 Stat. 100.

19 More precisely, I.R.C. § 1231 provides for a net capital gain if the recognized gains from sales or exchanges of property used in a trade or business, plus the recognized gains from the compulsory or involuntary conversion of property used in a trade or business and of capital assets, exceed the recognized losses from such transactions. If such gains do not exceed such losses, a net ordinary loss results. I.R.C. § 1231(a).

no gain was recognized on the liquidating distribution or preliquidation sales of such property pursuant to sections 336 and 337. Sections 1245 and 1250 apply to all dispositions of depreciable property and generally override all other Code provisions, including such nonrecognition provisions as sections 336 and 337.²⁰ In dispositions of personal property and certain types of real property, section 1245 recaptures as ordinary income all previously taken depreciation deductions up to gain realized.²¹ In dispositions of most types of real property, section 1250 effects a recapture generally only to the extent of excess over straight line depreciation.²²

In order to understand the application of the broad, judicially created tax benefit rule as it applies to section 336 and 337 transactions, it is first necessary to understand the development of the rule in two major areas of controversy: (1) the preliquidation sale of expensed assets, and (2) the preliquidation sale and incorporation transfer of accounts receivable with an unused bad debt reserve.

A. Preliquidation Sales of Expensed Property

Assets such as materials and supplies not held for sale to customers and having only a short useful life may be expensed under section 162. The taxpayer may thus recover the assets' full cost as a deduction in the taxable year of purchase even though their useful life may extend into the next taxable year.²³ On the other hand, assets with a longer useful life should be capitalized and their cost recovered by way of section 167 depreciation deductions over a period of years corresponding to the assets' useful life.

A corporation which is about to liquidate may have on hand assets whose full cost has been expensed in a prior taxable year but whose useful life has not yet ended. Since the cost of these assets has been fully recovered their basis will be zero. But since the assets have not yet been fully consumed, they will retain

Property used in a trade or business is defined generally as depreciable property and real property used in a trade or business. I.R.C. § 1231(b)(1). Prior to 1977, the required holding period for § 1231 property was more than six months. The holding period is now more than one year. See The Tax Reform Act of 1976, Pub. L. No. 94-455, tit. 14, §§ 1402(b)(1)(R), (b)(2), 90 Stat. 1732. Gains for the sale of short term trade or business property would be ordinary income since such gains are excluded from §§ 1231 and 1221. See § 1221(2). Gains from the sale of depreciable property held in an income producing activity not amounting to a trade or business (a rather narrow category) are afforded capital treatment under § 1221. The gain would be long term or short term capital gain depending on the holding period.

The predecessor of I.R.C. § 1231, section 117(j) of the 1939 Code, was added to the Code by § 151(b) of the Revenue Act of 1942, ch. 668, 56 Stat. 846. Prior to 1942, depreciable business property was generally afforded capital gain treatment by being included within the category of capital assets. During one brief period between 1938 and 1942, gains and losses from the sale of depreciable business property were treated as ordinary gains and losses. See Armstrong, *Capital Gain Treatment Should be Restored for Depreciable Business Property*, 41 TAXES 175, 183-85 (1963); McNerney, *Disallowance of Depreciation in the Year of Sale at a Gain*, 20 TAX L. REV. 615, 619 (1965).

20 I.R.C. §§ 1245(a)(1), (b), 1250(a)(1)(A), (d). The sole exception to recapture permitted in the corporate liquidation area concerns distribution of property by an 80 percent or greater subsidiary where the parent takes a carryover basis under I.R.C. § 334(b)(1). I.R.C. §§ 1245(b)(3), 1250(d)(3).

21 Depreciation subject to recapture is generally limited to that taken subsequent to December 31, 1961. I.R.C. § 1245(a)(2)(A).

22 In certain cases only a portion of the excess depreciation is recaptured. However, since December 31, 1975, such situations are very limited. See I.R.C. §§ 1250(a)(1)-(a)(3). In the case of property held for a year or less, I.R.C. § 1250(b)(1) effects a recapture of all depreciation.

23 See Treas. Reg. §§ 1.162-3 (1958), 1.162-12 (1972), 1.471-1 (1958); Smith Leasing Co. v. Commissioner, 43 T.C. 37, 40-41 (1964); Rev. Rul. 73-357, 1973-2 C.B. 40; Rev. Rul. 59-249, 1959-2 C.B. 55.

some market value. These assets do not come within any of section 337's specific exceptions to nonrecognition and, since they are not depreciable assets, they are not subject to the recapture rules of sections 1245 and 1250 which specifically override section 337.²⁴ Beginning in 1969 a series of cases considered whether, under the general, judicially created tax benefit rule, some portion of the previously taken expense deductions should be recaptured as income in the year of the preliquidation sale of expensed zero basis assets retaining some market value.

In the first case, *Commissioner v. Anders*,²⁵ the taxpaying corporation rented laundered towels, wiping and dusting materials, coveralls, and other items. Most of the rented items had a useful life of twelve to eighteen months. Following an admittedly proper practice, the corporation expensed and deducted the full cost of these items in the year of their purchase. Pursuant to a plan of liquidation under section 337, the corporation sold its expensed zero basis rental items for \$233,000. The taxpayer maintained that this sale resulted in gain nonrecognizable under section 337. The government contended that since the corporation had obtained a tax benefit when it deducted the cost of the items, the tax benefit rule required recognition of the gain. The Tax Court upheld the taxpayer, concluding that the tax benefit rule should not apply in the face of section 337's clear and unambiguous nonrecognition rule.²⁶ Distinguishing the assignment of income doctrine's application to section 337 liquidations, the court stated: "The sale was of assets, not income. The fact that their income-producing potential had not been exhausted when sold did not alter their character as property used in the business of the corporation."²⁷

The Tenth Circuit reversed, holding that section 337 contained no provision showing an intent to bar application of tax benefit principles fashioned under other Code provisions.²⁸ The court stated:

The fact that a transaction involves disposition of property does not compel treatment of the proceeds as gain from such a transfer. Instead, we conclude that tax benefit principles call for treatment of the proceeds not as gain from the sale of property, but as ordinary income which was deducted on its purchase.²⁹

The court distinguished *Fribourg Navigation Co. v. Commissioner*³⁰ in which the Supreme Court held that a taxpayer was entitled to take depreciation deductions in the year of sale of a business asset, and thus to achieve greater capital gain on sale due to downward adjustment to basis resulting from the depreciation. *Fribourg* dealt with facts arising prior to the enactment of sections 1245 and 1250.³¹ The Tenth Circuit stated that while some comparisons could be

24 I.R.C. §§ 1245(a)(3), 1250(c); see *Coca-Cola Bottling Co. v. United States*, 487 F.2d 528, 533-35 (Ct. Cl. 1973); Comment, 17 U. MIAMI L. REV. 619, 632 (1963).

25 414 F.2d 1283 (10th Cir. 1969) (*rev'g* 48 T.C. 815 (1967)), *cert. denied*, 396 U.S. 958 (1969).

26 48 T.C. at 821.

27 *Id.* at 823.

28 414 F.2d at 1287.

29 *Id.* at 1288.

30 383 U.S. 272 (1966).

31 See note 18 *supra*.

drawn between depreciation and expensing a rental item, in substance the methods are not the same.³² The former involves deductions over the useful life of an asset, while the latter involves "no realization of appreciation in value entitled to . . . treatment" as gain from the sale of an asset.³³

In 1970, the government achieved another victory in *Spitalny v. United States*.³⁴ In *Spitalny* the taxpayer expensed feed and supplies of its cattle feeding business and sold these assets later in the same taxable year pursuant to section 337. The government argued for the restoration to income of the sales price of these assets under the tax benefit rule. Alternatively, the government argued that since both the deduction and the sale took place in the same taxable year, the Commissioner could simply disallow the deduction pursuant to his authority under Section 446(b) to prevent distortion of income.

The Ninth Circuit agreed that the tax benefit rule can apply to expensed property despite section 337's nonrecognition rule.³⁵ The court declared:

We agree that feed and supplies on hand are "property" under Section 337(b) and, accordingly, that "gain" realized on their sale shall not be recognized. The crucial question, however, is whether "gain" was realized. The assignment of a zero basis to expensed items is not in response to adjustments in valuation. It amounts, rather, to a present fictional conversion of that "property" into a consumed item of expense. If the feed and supplies are to revert to "property" they should be reconverted. They should not at the same time . . . retain attributes of a fictional nonentity.

Under these circumstances what tax benefit principles do for purposes of computing gain under section 337 is to give to the property sold its true basis as property and deny to it the benefit of an adjusted basis which is false and distorting and inconsistent with its very existence as property.³⁶

The court conceded, however, that when both the deduction and the offsetting recovery occur in the same taxable year, it is appropriate to simply deny the deduction under section 446 (b) rather than resort to the tax benefit rule.³⁷ Regarding application of section 446(b), the court stated:

The expense deduction as permitted by regulation is intended to reflect the cost of feed *actually* consumed during the taxable year and to accomplish over a period of years roughly the same result as would have been had through use of the inventory method, but by a simpler form of accounting. Certainly it could never have been intended that the cash basis method, on liquidation, should provide such a startling advantage over the inventory method, which would truly reflect the cost of feed actually consumed.³⁸

The court remanded the case for a factual determination of the cost of the feed,

32 414 F.2d at 1288.

33 *Id.* See further discussion of *Fribourg* in text accompanying notes 102-107 *infra*.

34 430 F.2d 195 (9th Cir. 1970).

35 *Id.* at 197-98.

36 *Id.* at 198.

37 *Id.* at 197-98.

38 *Id.* at 197 (italics in original). Under I.R.C. § 446(b), in effect, the corporation would be placed on the inventory method of accounting as to the items in question. The cost of the items would thus enter into the computation of the "cost of goods sold," and merely offset the proceeds of the liquidation sale.

since if the feed were sold for more than its cost the sale price to that extent would be nonrecognizable under section 337.³⁹

The government also prevailed in decisions rendered by the Third Circuit,⁴⁰ the Court of Claims,⁴¹ and the district courts.⁴² Finally, in *Estate of Munter v. Commissioner*,⁴³ the full Tax Court, with no dissenters, held the tax benefit rule applicable to expensed items in liquidation sales under section 337. *Munter* involved the preliquidation sale of rental items which had been expensed either in the year of sale or in the two years preceding the sale. Section 337 permitted nonrecognition of gain from the sale. The Tax Court ruled that the receipt by the corporation of the additional tax benefit lacked legislative support and was inconsistent with the general intent of Congress in enacting revenue laws.⁴⁴ The court considered the tax benefit rule applicable to both deductions taken in the year of sale and deductions taken in prior years.⁴⁵

These cases firmly establish the applicability of the tax benefit rule to preliquidation sales of expensed assets. Although there is some uncertainty as to whether it is more proper to apply the tax benefit rule or section 446(b) to sales of assets expensed in the year of sale, the result to the taxpayer is the same under both principles—the economic benefit of the deduction is lost. These cases highlight the overriding role of the tax benefit rule: preventing distortions of income arising from the taxpayer's use of a particular method of accounting.

B. Bad Debt Reserve

Section 166(c) permits an accrual method taxpayer to deduct a reasonable reserve for bad debts instead of deducting specific bad debts. The amount of bad debt reserve is derived by estimating the losses which reasonably can be ex-

39 *Id.* at 198.

40 *Connery v. United States*, 460 F.2d 1130 (3d Cir. 1972) (involving prepaid advertising expenses).

41 *Anders v. United States*, 462 F.2d 1147 (Ct. Cl.), *cert. denied*, 409 U.S. 1064 (1972). In *Anders* the court adopted reasoning similar to that in *Spitalny* holding that gain was realized not from a sale but from a reconverting of previously expensed items into "property." *Id.* at 1149. The *Anders* court also took the position that the tax benefit rule should apply regardless of whether the deduction and recovery occur in the same taxable year. *Id.*

42 *S.E. Evans, Inc. v. United States*, 317 F. Supp. 423 (W.D. Ark. 1970); *Krajcek v. United States*, 36 A.F.T.R. 2d 75-5034 (D.N.D. 1975).

43 63 T.C. 663 (1975).

44 *Id.* at 676.

45 *Id.* at 677. In a footnote, the court stated that there was some similarity between the present case and *Fribourg Navigation Co., Inc. v. Commissioner*, 383 U.S. 272 (1966), which had allowed depreciation deductions in the year of sale. 63 T.C. at 677 n.7. The court did not believe, however, that there was an intention to expand the rationale of *Fribourg* to the *Munter* case.

In a concurring opinion two judges stated that it was unnecessary to base the rationale for the application of the tax benefit principle on notions such as whether the items involved are "property" or whether the proceeds of the disposition constitute "gain." 63 T.C. at 679. The tax benefit rule should simply be viewed as a "necessary counterweight to the consequences of the annual accounting principle . . ." *Id.* at 678. I.R.C. § 337 granted nonrecognition generally to gains from liquidating transactions but preserved the taxability of income arising in the ordinary course of business. Section 337 should not exempt actual recoveries of tax benefits; these recoveries should retain the characteristics of ordinary business income. *Id.* at 679. The opinion distinguished *Fribourg* by stating that "[d]epreciation has been and continues to be considered sui generis and the tension between the recovery of amounts preciously deducted and the tax benefit rule has not been considered of such a character as to cause that rule to prevail. See [Treas. Reg. § 1.111-1(a) (1956)] . . ." *Id.* Furthermore, without precluding application of the tax benefit rule to deductions taken in the year of sale, the concurring judges were of the opinion that the government could properly pursue its alternative theory under I.R.C. § 446(b) as to these deductions. *Id.* at 682.

See *Atec Corp.*, [1977] T.C.M. (P-H) ¶ 77,438, for a reaffirmation of the application of the tax benefit principle to expensed items under § 337.

pected to result from the worthlessness of debts outstanding at the close of the taxable year.⁴⁶ Under the reserve method, specific debts upon becoming worthless are charged against the reserve and reduce its credit balance. If the reserve's end of year credit balance cannot cover reasonably expected losses attributable to debts outstanding at the end of the year, an appropriate addition is made to the reserve. Such an addition is deductible.⁴⁷

In a series of cases prior to 1970, the courts held that upon liquidation of a corporation accounting for its bad debts under the reserve method, the tax benefit rule required that the remaining balance in the bad debt reserve be included in the corporation's income.⁴⁸ While these cases generally involved preliquidation sales pursuant to section 337, at least one case involved a liquidating distribution in kind in the liquidation of a subsidiary corporation pursuant to section 334(b)(2).⁴⁹ Language from earlier nonliquidation cases was often cited to the effect that a bad debt reserve previously deducted from income must be included in income in the year in which the need for the continuance of such a reserve ceases.⁵⁰ Some of the cases requiring inclusion of the bad debt reserve in the course of liquidation specifically rejected the taxpayer's contention that the reserve should not be included in income unless the amount realized on the sale of accounts receivable exceeded their adjusted basis or "net value" in the corporation's hands.⁵¹

In another series of pre-1970 cases, the courts considered whether a transferor of accounts receivable upon incorporation of the transferor's business must include the bad debt reserve in income. Section 351 provides for the nonrecognition of gain or loss on transfers of property to a corporation if the transferors own eighty percent or more of the corporation's stock immediately after the transfer. In *Estate of Schmidt v. Commissioner*,⁵² the Ninth Circuit rejected the Commissioner's contention that the transferor must include in income the bad debt reserve when all he receives in return is stock representing the receivables' face value less the reserve (net value). The Court stated that although the transferor no longer "needed" the reserve, in an "economic" sense he had not recovered the value of the reserve under these circumstances.⁵³ In *Max Schuster v. Commissioner*,⁵⁴ a majority of the Tax Court disagreed with *Schmidt*, holding that inclusion was required whether or not the value of the stock received equaled the net value of the receivables. In the Tax Court's view, inclusion was required because the transferor had taken a deduc-

46 See Treas. Reg. § 1.166-4 (1980).

47 J.E. Hawes Corp. v. Commissioner, 44 T.C. 705, 707 (1965).

48 See, e.g., West Seattle Nat'l Bank v. Commissioner, 288 F.2d 47 (9th Cir. 1961); Citizens Fed. Sav. & Loan Ass'n v. United States, 290 F.2d 932 (Ct. Cl. 1961); Bird Management, Inc. v. Commissioner, 48 T.C. 586, 594-97 (1967); Argus, Inc. v. Commissioner, 45 T.C. 705 (1965).

49 Argus, Inc. v. Commissioner 45 T.C. 63 (1965). See also First Nat'l State Bank v. Commissioner, 51 T.C. 419 (1968), where the taxpayer did not dispute the application of the tax benefit rule in a § 334(b)(2) distribution of accounts receivable with an unused bad debt reserve.

50 See, e.g., S. Rossin & Sons, Inc. v. Commissioner, 113 F.2d 652, 654 (2d Cir. 1940); Geyer, Cornell & Newell, Inc. v. Commissioner, 6 T.C. 96 (1946).

51 Bird Management v. Commissioner, 48 T.C. 586, 595-97 (1967); J.E. Hawes Corp. v. Commissioner, 44 T.C. 705, 708-09 (1965). But see West Seattle Nat'l Bank v. Commissioner, 288 F.2d 47, 50 (9th Cir. 1961). The adjusted basis of the accounts receivable would be their face value less the bad debt reserve.

52 355 F.2d 111 (9th Cir. 1966).

53 *Id.* at 113. Because there was no recovery in an economic sense, the court stated that it was immaterial whether the reserve could be considered as having been transferred to the new corporation. *Id.*

54 50 T.C. 98 (1968).

tion for anticipated bad debts which, due to incorporation, he would never sustain.⁵⁵ In addition, the court could find no provision in the statute permitting the carryover of a bad debt reserve from the transferor to the transferee corporation.⁵⁶

In *Nash v. United States*,⁵⁷ the Fifth Circuit adopted the Tax Court's position in *Schuster*. To resolve the conflict between the Ninth and Fifth Circuits, the Supreme Court reviewed *Nash*. The Court reversed the Fifth Circuit,⁵⁸ rejecting the Commissioner's argument that the "end of the need" could be equated with a "recovery" "in the present context."⁵⁹ The Court declined to rule that there was a recovery when the transferors received from the corporation only securities equal in value to the net value of the accounts transferred.⁶⁰ The Court stated that a "double benefit" to the transferor would have resulted only if securities equal in value to the face amount of the receivables⁶¹ had been issued.

In *Citizens Acceptance Corp. v. United States*,⁶² the district court considered the tax benefit rule's applicability to bad debt reserves in section 337 liquidations in light of the Supreme Court's holding in *Nash*. The court observed that many pre-*Nash* decisions had held that a corporation recognized the entire amount of its bad debt reserve upon liquidation pursuant to section 337.⁶³ The court considered *Nash* as overruling those decisions, since the considerations governing section 351 also govern section 337.⁶⁴ Accordingly, the court held that a bad debt reserve could be recaptured only to the extent the amount received for the accounts receivable in the preliquidation sale exceeded the receivables' net value. Although the Third Circuit reversed on factual grounds,⁶⁵ it impliedly accepted the district court's reasoning that under *Nash* the bad debt reserve could be recaptured only to the extent that the consideration received exceeded the net value of the receivables.⁶⁶ In Revenue Ruling 78-279,⁶⁷ the Internal Revenue Service accepted the district court's application of *Nash* to section 337 liquidations.⁶⁸

55 *Id.* at 102.

56 *Id.* In answer to this majority contention, the dissenting opinion by Judge Simpson stated that prior to the enactment of § 381, without specific statutory authorization, in some circumstances the courts had permitted the carryover of tax attributes in a corporate reorganization. *Id.* at 103-04.

57 414 F.2d 627 (5th Cir. 1969), *rev'd*, 398 U.S. 1 (1970).

58 398 U.S. 1 (1970).

59 *Id.* at 3-4.

60 *Id.* at 4.

61 *Id.* at 5. In Rev. Rul. 78-280, 1978-2 C.B. 139, the Service explained the proper treatment of accounts receivable in the corporation's hands in a § 351 transaction in light of the *Nash* case.

62 320 F. Supp. 798 (D. Del. 1970), *rev'd on other grounds*, 462 F.2d 751 (3d Cir. 1972).

63 320 F. Supp. at 804.

64 *Id.* at 803-04.

65 462 F.2d at 755-56. The Third Circuit reversed on the factual question of the extent to which the amount realized on the sale exceeded the net value of the receivables. *But see* Home Sav. & Loan Ass'n v. United States, 514 F.2d 1199 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975).

66 462 F.2d at 757.

67 Rev. Rul. 78-279, 1978-2 C.B. 135. The Service stated:

The burden is on the taxpayer to show that the amount received in excess of the net value of the accounts receivable is not a recovery of a tax benefit but rather attributable to economic factors such as appreciation in value of interest bearing accounts receivable resulting from changes in prevailing interest rates.

Id. at 136.

68 Rev. Rul. 78-278, 1978-2 C.B. 134, held similarly with respect to liquidating distributions in kind in liquidations of an 80 percent or more subsidiary pursuant to I.R.C. §§ 332, 334(b)(2).

In view of *Nash* and the subsequent developments in the section 337 area, the law is well settled as to preliquidation sales of accounts receivable where unused bad debt reserves exist. However, *Nash* does raise the question whether a taxpayer must have a "recovery" or "economic benefit" for the tax benefit rule to apply. This question is crucial in determining the applicability of the tax benefit rule to liquidating distributions in kind.

C. Liquidating Distributions of Expensed Assets

Two cases have considered the applicability of the tax benefit rule to liquidating distributions of expensed zero basis assets. Both *Commissioner v. South Lake Farms*⁶⁹ and *Tennessee Carolina Transportation, Inc. v. Commissioner*⁷⁰ involved liquidating distributions by eighty percent or greater subsidiaries to parent corporations which had purchased the stock and then promptly adopted a plan of liquidation. Under section 332 each parent acquired its subsidiary's assets tax free. Under section 334(b)(2) each parent's basis in those assets equaled the price paid for the subsidiary's stock, with certain adjustments.⁷¹ This basis approximated the parent's basis had it simply purchased the assets directly. Under the regulations⁷² the precise basis of each acquired asset was determined by allocating the price of the stock among the assets in accordance with their fair market values on the date of the stock's purchase.

In *South Lake Farms*, the assets distributed to the parent consisted in part of a cotton crop ready for harvesting and land prepared for the planting of barley. During the taxable year of the liquidation and the preceding year, the subsidiary had totally expensed its costs in planting the cotton crop and preparing the land for the barley crop, taking approximately \$700,000 in deductions. Under section 334(b)(2) the parent took a total basis in the cotton crop and land preparation of approximately \$1,800,000. The parent then offset against its gross receipts from the cotton and barley crops its acquired basis of \$1,800,000, as well as its subsequent harvesting and planting costs.

The Commissioner's first contention, based on section 446(b), was that the subsidiary should include as income in its last taxable year the \$1,800,000 fair market value of the cotton crop and land preparation on the date of liquidation. The Commissioner argued it would be a distortion of income should the

See also *Messer v. Commissioner*, 438 F.2d 774, 780 (3d Cir. 1971) (tax benefit rule applied to amount received during § 337 liquidation in settlement of a contested royalty obligation formerly deducted from income); *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964) (tax benefit rule applied to subscription reserves in § 337 liquidation); and *Bishop v. United States*, 324 F. Supp. 1105 (M.D. Ga. 1971) (tax benefit rule overrode that portion of § 337 which extends nonrecognition treatment to bulk sales of inventory). For a result similar to that in *Bishop*, see *Winer v. Commissioner*, 371 F.2d 684 (1st Cir. 1967). In Rev. Rul. 74-431, 1974-2 C.B. 107, the Service held that the tax benefit rule did not apply to a § 337 bulk sale of LIFO inventory. But see the 1980 amendments to §§ 336 and 337 with respect to LIFO inventory. Pub. L. No. 96-223, §§ 403(b)(1), (b)(2)(A), 94 Stat. 304, adding §§ 336(b) and 337(f).

69 324 F.2d 837 (9th Cir. 1963), *aff'd* 36 T.C. 1027 (1961).

70 582 F.2d 378 (6th Cir. 1978), *rev'd* 65 T.C. 440 (1975), *cert. denied*, 440 U.S. 909 (1979).

71 The § 334(b)(2) basis applies when one corporation acquires 80% of the stock of another corporation by purchase within a twelve month period and within two years thereafter adopts a plan to liquidate the acquired corporation. The normal basis of the parent in the assets acquired in the liquidation of an 80 percent subsidiary is that of the subsidiary. I.R.C. § 334(b)(1).

72 Treas. Reg. § 1.334-1(c)(4)(vi)(b)(1972).

taxpayer deduct the operation's expenses without reporting its income.⁷³ However, the Ninth Circuit rejected this argument on the ground that under no method of accounting could the taxpayer be deemed to have earned income from the unharvested cotton and the unplanted barley.⁷⁴

The Commissioner's alternative argument sounded in "tax benefit," although it relied directly on section 446(b). The Commissioner observed that the price of the subsidiary's stock was dependent upon the value of the cotton crop and the land preparation, and that part of the stock purchase price had been allocated to the cotton crop and land preparation for the purpose of fixing the purchasing corporation's basis under section 334(b)(2). The Commissioner argued that the subsidiary had consequently "received an amount equivalent to, and sufficient to offset, the expenses it had incurred, and hence was no longer entitled to the 'tax benefit' of the deduction of these expenses."⁷⁵

The Ninth Circuit rejected the government's alternate argument, declaring:

One immediate difficulty with this contention is that the old corporation received nothing. It was the stock of the old corporation that was sold, and the stockholders who got the money. The price that they got was higher because of the values added to the old corporation's assets by the expenditures that were made in preparing the barley lands and in preparing, planting, and growing the cotton crop. No doubt they paid tax on the increased gain. Nowhere in the Code do we find an intent that gains of the stockholders were to be attributed to the corporation, much less that they were to be treated as ordinary income to the corporation. The corporation is to be taxed only on its own income.⁷⁶

In *Tennessee-Carolina*, the subsidiary corporation, a motor freight transportation operation, distributed to its parent in the course of liquidation some 1600 tires and tubes whose cost had been previously expensed. At the time of distribution, 67.5% of the useful life of these tires and tubes remained. The government conceded that the parent was entitled to deduct in the year of acquisition the fair market value of the tires and tubes on the date of acquisition—its basis for such items under section 334(b)(2).⁷⁷ The government argued, however, that the subsidiary was required to recognize income on the distribution of the tires and tubes under the tax benefit rule.

The majority of the Tax Court agreed with the government, holding that the subsidiary had gross income to the extent of the lesser of (1) the fair market value of the tires and tubes distributed, and (2) the portion of the cost of the

⁷³ 324 F.2d at 838; 36 T.C. at 1035-37.

⁷⁴ 324 F.2d at 838-39. The Tax Court similarly rejected the Commissioner's argument. 36 T.C. at 1037-40.

⁷⁵ 324 F.2d at 839.

⁷⁶ *Id.* In the Tax Court, the Commissioner based his alternative argument on I.R.C. § 482, not § 446(b). 36 T.C. at 1040-41. Section 482 provides that, in the case of any two or more corporations, owned or controlled by the same interests, the Commissioner may allocate gross income or deductions between the corporations if necessary to prevent evasion of taxes or to reflect clearly the income of such entities. The Tax Court rejected this argument, holding that under § 482 the Commissioner could not simply disallow a deduction to one corporation without allocating it to another corporation. The allowance to the purchasing corporation of a fair market value basis of the items in question was not the allocation of a deduction, but merely the allowance of the basis to which it was entitled under § 334(b)(2). 36 T.C. at 1042.

On appeal to the Ninth Circuit, there was a long dissenting opinion based on tax benefit and assignment of income principles and I.R.C. §§ 446(b) and 482. 324 F.2d at 840-53.

⁷⁷ 65 T.C. at 446 n.4.

stock attributable to the tires' and tubes' useful life remaining on the date of distribution.⁷⁸ The majority disagreed with the Ninth Circuit's apparent position in *South Lake Farms* precluding "recovery" under the tax benefit rule unless the acquiring corporation has actually received or become entitled to receive money or property.⁷⁹

The Sixth Circuit affirmed the Tax Court, rejecting the argument that there was no "recovery" on three grounds.⁸⁰ First, citing a dictum in *Block v. Commissioner*,⁸¹ a 1939 Board of Tax Appeals decision, the court held that the tax benefit rule should apply not only if there is a physical recovery of a tangible asset or sum but also if there is another event inconsistent with the prior deduction. Here, the transfer to the acquiring corporation of tires and tubes having a substantial remaining useful life was inconsistent with their prior expensing which indicated that the tires and tubes had been or would be totally used by the subsidiary.

Second, following the Tax Court's reasoning,⁸² the court noted that when the tires and tubes were expensed their basis became zero and they became nonentities for tax purposes on the assumption that they would be consumed by the subsidiary. The transfer of these still useful assets in liquidation is inconsistent with this assumption. Thus, in transferring these assets the subsidiary must be deemed to have recovered them. Third, the court held that a recovery occurred in that the subsidiary received its own stock in exchange for the transferred assets. Although it had no value after the liquidation, the stock had considerable value at the time of its receipt by the subsidiary.

The Sixth Circuit denied that *United States v. Nash*,⁸³ dealing with the transfer of accounts receivable under section 351, stood for the proposition that there must be an actual physical recovery of previously deducted amounts.⁸⁴ The court distinguished *Nash* on two grounds.⁸⁵ First, *Nash* involved not the transfer of an item which had been the subject of a prior deduction, but only the transfer of what remained after the deduction.⁸⁶ Second, the bad debt reserve deduction in *Nash* "reflected business reality since only the net value of the receivables could realistically be recovered; here the expense deduction did not reflect business reality since the tires and tubes were not in fact consumed by [the subsidiary]."⁸⁷

In addition, the Sixth Circuit observed that a finding of no recovery would produce an unnecessary disparity between liquidations under section 336 and

78 *Id.* at 448.

79 *Id.* at 447. A concurring opinion by Judge Simpson emphasized that no position was being expressed as to the tax consequences of expensed property's distribution in a liquidation not governed by I.R.C. § 334(b)(2). 65 T.C. at 449.

80 582 F.2d at 382.

81 39 B.T.A. 338, 341 (1939), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940). The statement in *Block* is dictum because an actual recovery was involved under its facts.

82 65 T.C. at 447-48.

83 398 U.S. 1 (1970), discussed in text accompanying notes 58-61 *supra*.

84 582 F.2d at 382-83.

85 *Id.* at 383.

86 *Id.*

87 *Id.* The majority opinion in the Tax Court stated that *Nash* supported its position in *Tennessee-Carolina* since *Nash* implied that the bad debt reserve would have been includable in income to the extent the fair market value of the receivables exceeded their net worth. 65 T.C. at 449. The present situation is analogous to one in which the fair market value of the receivables exceeds their net worth.

those under section 337.⁸⁸ This disparity would have been evident in the present case had the subsidiary sold its assets to the parent and then made a liquidating distribution of the proceeds to its shareholders. In such an event section 337 would not have precluded application of the tax benefit rule.⁸⁹ The court stated that section 336 liquidations should be treated like section 337 liquidations as a general rule unless some peculiar provision of section 337 justifies different treatment.⁹⁰ No such statutory justification existed in the present case. Indeed, the court noted that section 337 was enacted precisely to eliminate formalistic distinctions between liquidating distributions in kind and preliquidation sales.⁹¹

The dissenting judges in the Tax Court and the Sixth Circuit objected to the application of the tax benefit rule in a section 336 distribution because of the absence of any economic recovery by the distributing corporation.⁹² In contrast, a section 337 preliquidation disposition would have resulted in such a recovery. The dissenting judges in the Tax Court, however, would have permitted an adjustment in the case of a liquidating distribution in kind if the deduction was taken in the year the distribution of assets was made. The adjustment would take the form of a denial of the deduction pursuant to the Commissioner's section 446(b) authority to change a taxpayer's accounting method when that method does not clearly reflect income.⁹³

The dissenters in both the Tax Court and the Sixth Circuit pointed to the fact that all the cases supporting the government's position involved an economic recovery through either (1) receipt of funds or (2) release of an accrued liability increasing the taxpayer's net worth.⁹⁴ According to the dissenters, the only recovery that could be considered to have taken place in *Tennessee-Carolina* was the distributing corporation's receipt of its own stock. Such receipt could not be considered an economic recovery, since a corporation's stock has no value when the corporation has terminated its business and distributed its assets.⁹⁵ The dissenters also found the majority's holding inconsistent with *Nash*, seeing no difference between the "end of the need" argument rejected by the Supreme Court in *Nash* and the "inconsistent event" rationale embraced by the majority in *Tennessee-Carolina*.⁹⁶

The dissenters also asserted that Congress had nowhere evidenced an in-

88 582 F.2d at 380-81, 383.

89 See text accompanying notes 19-38 *supra* for treatment of § 337 deductions.

90 582 F.2d at 381.

91 *Id.* at 383.

92 65 T.C. 440, 449-55; 582 F.2d 378, 383-88. The majority cited I.R.C. § 337(b)'s "unique denial of nonrecognition to gain or loss from sales in the ordinary course of business during the relevant twelve-month period" as a provision with no counterpart in I.R.C. § 336. 582 F.2d at 381 n.10. See *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973).

93 65 T.C. at 454-55. Six other judges concurred in Judge Tannenwald's dissent.

94 65 T.C. at 450; 582 F.2d at 384. Situation (1) is exemplified by *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), in which a taxpayer who took a deduction for estate taxes paid in one year was required to include as income a refund of the taxes received in another year. Situation (2) would be exemplified by *Mayfair Minerals, Inc., v. Commissioner*, 56 T.C. 82 (1971), *aff'd per curiam*, 456 F.2d 622 (5th Cir. 1972). In *Mayfair Minerals* a taxpayer had deducted as an accrued liability the amount of refunds it was required to make to its customers under a challenged order of the Federal Power Commission. The taxpayer was required to include the amount formerly deducted as income in the year in which "its contingent liability to make the refunds terminated, the account payable was closed, and the money which the accruals represented became available for its general use." 56 T.C. at 87.

95 65 T.C. at 451; 582 F.2d at 385.

96 65 T.C. at 451; 582 F.2d at 384-85. See text accompanying notes 53-57 *supra*.

tent that all liquidations under sections 336 and 337 should have the same tax result.⁹⁷ Instead, they declared Congress' concern in enacting section 337 was the elimination of corporate level tax differences resulting from court opinions which made tax consequences turn on whether a liquidating corporation rather than its shareholders sold the assets. The Sixth Circuit dissent concluded:

[I]n justifying the application of the tax benefit rule to the facts of the case by relying on Section 337 cases, [the majority] fail to perceive that Section 337 was enacted as a shield to protect the taxpayer, and not as a sword to be utilized by the government.

If there is to be a parity in tax treatment under the two sections, the tax results dictated by Section 336 should control Section 337, and not vice versa.⁹⁸

D. Analysis of *Tennessee-Carolina*

A simple illustration will typify the *Tennessee-Carolina* facts. S Corporation, a calendar year taxpayer, acquires a business asset in mid-1979 for \$100. Since the asset has a useful life of one year, S properly expenses the cost under section 162 and receives a \$100 tax deduction in its 1979 tax return. S's basis in the asset is thus zero. At the beginning of 1980, P Corporation acquires all the stock of S Corporation and immediately liquidates S pursuant to section 334(b)(2). S's only asset at the time of its acquisition by P is the expensed asset which has a remaining useful life of six months. The asset has a fair market value of \$50, since the asset is half consumed. S has no outstanding liabilities immediately prior to the acquisition.

Under *Tennessee-Carolina*, in distributing the expensed asset S Corporation must include in its 1980 taxable income the lesser of (1) the fair market value of the asset or (2) the portion of the cost attributable to the asset's remaining useful life as of the date of distribution.⁹⁹ Under our facts (1) and (2) are the same figure—\$50. Assuming an effective tax rate of twenty percent, S will incur a tax liability of \$10. Under section 334(b)(2), P takes a basis in the asset equal to its cost for the stock (\$50) plus, presumably, an additional \$10 to reflect P's additional out-of-pocket expense in assuming S's tax liability.¹⁰⁰ P,

97 65 T.C. at 453; 582 F.2d at 387-88.

98 582 F.2d at 388. The Sixth Circuit dissent contended that the subsidiary's shareholders, and not the subsidiary, recovered the tax benefit resulting from the expensing of the tires and tubes. *Id.* at 384-85. The dissent also contended that the "fictional reconversion" rationale used in *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970), "did not constitute the requisite recovery for tax benefit purposes, but rather, was used to circumvent the nonrecognition provision of § 337 so that the tax benefit rule could be applied." 582 F.2d at 387; see quotation in text accompanying note 36 *supra*.

99 *Tennessee-Carolina Trans., Inc. v. Commissioner*, 65 T.C. at 448.

100 Under I.R.C. § 334(b)(2), the Treasury is authorized to adopt regulations prescribing adjustments in the parent's basis in the subsidiary's stock "for any liabilities assumed or subject to which the property was received, and for other items." Under Treas. Reg. § 1.334-1(c)(4)(v) (1960), the parent's basis in the subsidiary stock must be increased:

- (1) by the amount of any unsecured liabilities assumed by the parent, and
- (2) by the portion of the subsidiary's earnings and profits (less the amount of any distributions therefrom) of the period beginning on the date of purchase and ending upon the date of the last distribution in liquidation attributable to the stock of the subsidiary held by the parent.

The impact of this regulation on the parent's basis when the subsidiary must recognize income on the distribution of expensed assets is not entirely clear. See O'Hare, *Application of Tax Benefit Rule in New Case Threatens Certain Liquidations*, 44 J. Tax. 200, 202-03 (1976). Arguably, the regulations require that, in our example in the text, the parent increase its basis in the asset to \$100. The components of the \$100 basis would be as follows: (1) \$50, the cost of the stock; (2) \$10, the tax liability of the subsidiary arising from ap-

which will use the asset for the remainder of its useful life, will properly take an immediate deduction for its full cost of the asset (\$60).

The treatment of S and P under *Tennessee-Carolina* conforms with sound tax policy and represents a proper economic result. If S is to obtain an immediate deduction for the full cost of the asset it should fully consume the asset in its business. If S disposes of the asset prematurely, some accounting mechanism must be employed to prevent the resulting distortion. The tax benefit rule in effect limits S to a deduction for half the asset's cost;¹⁰¹ a result which comports with the fact that S used the asset for only half its useful life.

Tennessee-Carolina is consistent with *Fribourg Navigation Co. v. Commissioner*,¹⁰² which involved depreciation deductions taken prior to enactment of the recapture provisions in sections 1245 and 1250. The taxpayer in *Fribourg* had purchased a used Liberty ship for \$469,000 on December 21, 1955. With the Service's approval, the taxpayer depreciated the ship on a straight line basis assuming that its useful life was three years and that its value after those three years would be \$54,000. The taxpayer took depreciation for the ten days remaining in 1955 and the whole of 1956, adjusting its basis by the \$326,627 depreciation. During 1957, the market value of ships rose sharply due to the Suez Canal crisis. The taxpayer sold the ship for \$695,500 in a section 337 transaction on December 23, 1957. The taxpayer claimed \$135,367 in depreciation on the ship for 357 days of 1957 and argued that its \$504,239 gain was tax-free under section 337.

Because the recapture of depreciation provisions had not been enacted at that time,¹⁰³ section 337 made the entire gain tax-free. The Commissioner, however, sought to deny the depreciation deductions taken in 1957 by arguing that, since the ship's sale price exceeded the adjusted basis as of the beginning

plication of the tax benefit rule, assumed by the parent; and (3) \$40, the net increase in the earnings and profits arising from the recognition of income by the subsidiary (\$50 of recognized income minus \$10 of tax liability). This result is supported by two cases involving the analogous situations of the subsidiary recapturing either depreciation under I.R.C. §§ 1245 and 1250 or recapturing an unused bad debt reserve under pre-Nash law. *R.M. Smith, Inc. v. Commissioner*, 69 T.C. 317, 323-28 (1977), *aff'd*, 591 F.2d 248 (3d Cir.), *cert. denied*, 444 U.S. 828 (1979); *First Nat'l State Bank v. Commissioner*, 51 T.C. 419 (1968). The result seems unsupportable as a matter of policy. Under such an approach, the parent would be taking a basis of \$100 in the expensed asset when its out of pocket cost was only \$60 (\$50 cost of the stock plus \$10 of assumed tax liability). Moreover, although differing tax results might ensue because the tax brackets of the parent and subsidiary might differ, nevertheless, the granting of a \$100 basis to the parent essentially negates the consequences of forcing the subsidiary to recognize \$50 of income upon distributing the asset.

The preferable approach grants a \$60 basis to the parent (the \$50 cost basis of the stock adjusted by the assumption of the \$10 tax liability of the subsidiary). This approach has been put forth by a number of commentators and is apparently the government's approach. See O'Hara, *Liquidation of Subsidiaries—Basis—Sec. 334(b)(2)*, 16-4th TAX MNGM'T (BNA) A19-21 (1978); Horvitz, *Depreciation Recapture—Corporate Transactions*, 268 TAX MNGM'T (BNA) A48-51 (1972). The adjustment to basis prescribed by the regulations should be confined to sales and exchanges of assets occurring between the purchase of the subsidiary's stock and liquidation of the subsidiary, and should not embrace gain generated by the distribution of the subsidiary's assets. O'Hara, *supra*.

If income is generated by the distribution of an asset because of the depreciation recapture rules or the tax benefit doctrine, there is some question whether the resulting increase in the parent's basis is to be relegated solely to the asset generating the increase or is to be distributed among all the distributed assets in proportion to their net fair market value. See O'Hara, *supra*, at 202; Horvitz, *supra* at A51-53; Morrison, *Assignment of Income and Tax Benefit Principles in Corporate Liquidations*, 54 TAXES 902, 920-22 (1976). This question is not presented by the facts in the example in the text because the expensed asset is the only asset distributed.

101 The restoration to income of a previously deducted amount does not necessarily lead to the precise dollar amount resulting had the deduction not been taken in the first place. In the year of restoration, the taxpayer may be in a tax bracket different than the one in the year of deduction.

102 383 U.S. 272 (1966).

103 See note 18 *supra*.

of that year, the use of the ship during the year of sale "cost" the taxpayer nothing.¹⁰⁴ The United States Supreme Court rejected the Commissioner's contention, stating:

By tying depreciation to sale price in this manner, the Commissioner has commingled two distinct and established concepts of tax accounting—depreciation of an asset through wear and tear or gradual expiration of useful life and fluctuations in the value of that asset through changes in price levels or market values.¹⁰⁵

The Court held that depreciation cannot be disallowed when there is no challenge to the accuracy of the original estimates of useful life and salvage value, and that depreciation cannot take into account fluctuations in value due to market appreciation.¹⁰⁶

Fribourg does not run counter to the argument that in our example, S Corporation should be limited to a \$50 deduction because it only utilized the asset over half of its useful life. *Fribourg* merely held that in calculating depreciation deductions, one cannot take into account subsequent increases in the asset's market value. Increases in market value have no bearing on S and P's situation. All that should be taken into account is the fact that the taxpayer, having deducted the entire expense of the asset, has disposed of the asset before the end of its useful life. If in S and P's situation the market value of the asset increased to \$75, only \$50 would be required to be returned to income. This gain is attributable to the prior deduction¹⁰⁷ and not to market appreciation. The other \$25 realized is gain attributable to market appreciation and would escape taxation under section 336.¹⁰⁸

Limiting S's deduction to that portion of the asset's cost corresponding to the time during which S actually used the asset comports with depreciation policy. Depreciation is calculated over the useful life of an asset on a daily basis.¹⁰⁹ Expensing, like depreciation, is a method of cost recovery. If an asset has a short useful life, the taxpayer is granted the benefit of taking a deduction for its entire cost in the year in which the asset is first put to use. This should not, however, change the end result. The taxpayer is deemed to have been granted the deduction on the assumption that the asset will be used for its entire useful life. To the extent the taxpayer does not use the asset for its entire

104 383 U.S. at 276.

105 *Id.*

106 *Id.* at 276-79.

107 Compare *Bishop v. United States*, 324 F. Supp. 1105, 1111 (M.D. Ga. 1971).

108 See text accompanying notes 5-7 *supra*.

109 A rapid recovery of cost in the early years of an asset's life can be achieved by using accelerated methods of depreciation. See Treas. Reg. § 1.167(b) (1973). In contrast, the straight line method spreads the recovery of cost evenly over the life of the asset. Prior to the enactment of the recapture rules in §§ 1245 and 1250, downward adjustments to basis caused by accelerated depreciation often resulted in greater capital gain on disposition. This was one of the reasons for the enactment of §§ 1245 and 1250. See H.R. REP. NO. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 470-71. The capital gain result for depreciable business property was dictated specifically by § 1231. See discussion of § 1231 in note 19 *supra*. Presumably because of this specific grant of capital gain treatment, no attempt was ever made by the government to override § 1231 or §§ 336 or 337 by applying the judicially created tax benefit principle to dispositions of depreciable property. Sections 1245 and 1250 now override §§ 1231, 336 and 337.

If the tax benefit doctrine were not applied to the disposition of an expensed asset, the gain recognized on a regular, nonliquidation sale of such an asset would be entirely capital. An expensed asset is not within any of the specific exclusions to the definition of a capital asset in § 1221. Not being a depreciable asset, an expensed asset would not be within § 1231.

useful life, as a matter of proper tax accounting there must be an adjustment in the taxpayer's taxable income.¹¹⁰

The dissenters in *Tennessee-Carolina* objected to the application of the tax benefit rule because a corporation enjoys no economic recovery when it distributes assets to its shareholders, whereas it does make an economic recovery when it sells its assets. The Tax Court dissenters would have permitted an accounting adjustment pursuant to section 446(b) if the deduction had been taken in the same year as the distribution of assets.¹¹¹ No adjustment by way of the tax benefit rule could be made if the deduction were taken in a year prior to the distribution.

Two arguments could be made that the subsidiary in *Tennessee-Carolina* enjoyed an economic recovery. The first argument is that the subsidiary had an economic recovery in receiving its own stock in return for the assets distributed. Immediately prior to distribution of the assets, the stock's value equaled the value of the distributed assets. Section 331 treats the retirement of stock for assets as a sale or exchange for the purpose of providing capital gain treatment to the gain realized by the shareholder.¹¹² This argument, rejected by the dissenters in *Tennessee-Carolina*,¹¹³ is open to the objection that the stock is being exchanged solely for the purpose of cancellation pursuant to termination of the corporation's existence. The second argument is based upon a characterization of a section 334(b)(2) transaction as essentially a sale of the subsidiary's assets to the parent followed by a liquidating distribution.¹¹⁴ Although for basis purposes, section 334(b)(2) treats the parent as if it had purchased the subsidiary's assets rather than its stock, it does not follow that a sale of assets can be imputed to the subsidiary for purposes other than prescribing the parent's basis in the acquired assets. Moreover, the argument furnishes a narrow base for the result reached in *Tennessee-Carolina* because its rationale would not cover other liquidation transactions such as a liquidating distribution in kind to an individual shareholder or a less than eighty percent corporate parent.

Rather than rely on these two tenuous arguments, it seems better to rely on the majority's first argument in *Tennessee-Carolina* that an event inconsistent with the prior deduction suffices to trigger application of the tax benefit rule. The majority's second argument—that the subsidiary, not having fully consumed the expensed asset after taking a deduction for its full cost, must be deemed to have received the asset at the time of liquidation—appears to be no more than a further elaboration of the “inconsistent event” argument.

The essence of the “inconsistent event” argument is that the taxpayer was granted a deduction for the full cost of the asset on the assumption that the taxpayer would fully utilize the asset. The transfer of the asset when it has a remaining useful life and when the transferee takes a step-up in basis to a fair market value reflecting the remaining useful life is inconsistent with the prior

¹¹⁰ See Note, 21 VAND. L. REV. 995, 1007 (1968); *But see* Dobson v. Commissioner, 320 U.S. 489, 506-07 (1943).

¹¹¹ 65 T.C. at 454-55.

¹¹² See *Tennessee-Carolina Transp., Inc. v. Commissioner*, 582 F.2d 378, 382 n.15.

¹¹³ See text accompanying footnote 95 *supra*.

¹¹⁴ This argument was alluded to by the Tax Court dissent (65 T.C. at 452-53) and by the Sixth Circuit majority (582 F. 2d at 382 n.14).

deduction for the full cost of the asset. Consequently, in the year in which the inconsistent event occurs, the taxpayer must restore the prior deduction to income to the extent the taxpayer did not consume the asset in its business.¹¹⁵

The event triggering application of the tax benefit rule usually involves an economic recovery since the acquired enterprise usually continues rather than terminates its business. Because it may be difficult to conceptualize a true economic recovery when a corporation makes a distribution in the course of terminating its business, the decisive factor should be the presence not of an economic recovery but of an event inconsistent with the taking of a prior deduction. An economic recovery is simply the usual manifestation of an "inconsistent event."¹¹⁶

The tax benefit rule has been designed by the courts as a tool for correcting the distortion resulting from a taxpayer's taking a deduction which, in the light of subsequent events, exceeds his loss or cost.¹¹⁷ The extension of the rule to the liquidating distribution of an expensed asset is within this basic rationale and policy.¹¹⁸

Much can be said for the argument of the Sixth Circuit dissent in *Tennessee-Carolina*¹¹⁹ that the same tax consequences do not necessarily attend a section 336 distribution as a section 337 sale and that section 337 was enacted merely to eliminate the technical distinctions arising from the attribution to a corporation of sales by shareholders.¹²⁰ Nevertheless, from a tax policy standpoint it does not make sense that in applying a judicially created rule intended to avoid income distortions, results should differ depending on whether a corporation liquidates by way of section 336 or 337. The assignment of income doctrine has been applied in equal measure to both section 336 and 337 transactions.¹²¹ The same should hold true for the tax benefit rule.

The result in *Nash*¹²² is consistent with the application of the tax benefit rule in the *Tennessee-Carolina* situation. *Nash* involved a section 351 transfer of accounts receivable with an unused bad debt reserve. The *Nash* Court held that there was no "recovery" because the value of the stock did not exceed the net value of the receivables. This net value equaled the transferor's adjusted basis in the receivables (face value less bad debt reserve). Thus, no gain was realized in any sense. Nor was any double tax benefit involved. Under section 362 the transferee corporation took the same basis in the receivables as they had in the hands of the transferor. The transferee corporation could not deduct as an ad-

115 This is true providing the fair market value of the distributed asset is not less than the portion of the cost attributable to its remaining useful life. The precise formula for determining the amount to be restored to income is set forth in text accompanying note 78 *supra*.

116 But see dictum in *Block v. Commissioner*, 39 B.T.A. 338, 341 (1939).

117 Bittker and Kanner, *supra* note 13, at 267-70. See *Estate of Munter v. Commissioner*, 63 T.C. 663, 678-79 (1975) (Tannenwald, J. concurring); *Barnett v. Commissioner*, 39 B.T.A. 864, 867 (1939). In a dictum in *Barnett* the Board of Tax Appeals used "inconsistent event" language similar to that in *Block v. Commissioner*, 322 U.S. 275, 285-87, 289-90 (1944). But see *United States v. Skelly Oil Co.*, 394 U.S. 678, 684-85 (1969).

118 The Seventh Circuit has recently endorsed the "inconsistent event" rationale of *Tennessee-Carolina*. *First Trust & Sav. Bank v. United States*, 614 F.2d 1142, 1146 (7th Cir. 1980), *aff'g* 44 A.F.T.R. 2d 5253 (C.D. Ill. 1979). However, a traditional "recovery" occurred under the facts of that case. See also *Rosen v. United States*, 611 F.2d 942 (1st Cir. 1980).

119 See text accompanying notes 97-98 *supra*.

120 See authorities cited at note 9 *supra* and *Midland-Ross Corp. v. United States*, 485 F.2d 110, 117-18 (6th Cir. 1973).

121 See cases cited at note 11 *supra*.

122 See discussion of *Nash* in text accompanying notes 58-61 *supra*.

dition to its bad debt reserve the difference between the face amount of the receivables and its basis in the receivables. This amount was already deducted by the transferor in setting up its own bad debt reserve and was reflected in the transferee's basis in the receivables.¹²³

Tennessee-Carolina, however, involved entirely different facts. In that case the subsidiary transferred assets in which it had a zero basis due to its taking a prior deduction for the assets' full cost. The assets retained a fair market value because they were only partially consumed. Thus, the value of the assets distributed exceeded the corporation's basis in the assets, and the assets' value was reflected in the value of the stock immediately before liquidation. Moreover, in *Tennessee-Carolina* unlike *Nash*, there would be a "doubling" of deductions if the tax benefit doctrine were not applied. The subsidiary in *Tennessee-Carolina* had received a deduction for the full cost of the assets even though it had only partially consumed them. The parent took a step-up in basis to fair market value under section 334(b)(2), and could thus deduct its full cost in the assets. Failure to apply the tax benefit doctrine would have had the unsound effect of allowing two corporations to deduct their full cost in the assets even though one corporation transferred those assets to the other in a usable state.¹²⁴

123 Rev. Rul. 78-280, 1978-2 C.B. 139, 140. This ruling generally discusses the treatment of accounts receivable in the hands of the corporation after a § 351 transfer in light of the *Nash* case. The ruling sets forth guidelines for corporations using the reserve method for bad debts and for corporations using the specific charge-off method. In both situations, the ruling prevents the corporation from taking a deduction with respect to accounts receivable already taken by the transferor. Compare *Nash v. United States*, 398 U.S. 1, 4-5.

The same considerations are involved in a § 337 sale of accounts receivable to which *Nash* was applied in *Citizens' Acceptance Corp. v. United States*, 320 F. Supp. 798 (D. Del. 1970), *rev'd on other grounds*, 462 F.2d 751 (3d Cir. 1972). If the proceeds from the § 337 sale do not exceed the net value of the accounts receivable, there will be no income to the liquidating corporation. Because the amount realized does not exceed the corporation's adjusted basis in the receivables (face less bad debt reserve), the corporation has not realized gain in any sense. Furthermore, as in the § 351 situation, there is no double tax benefit. The buyer will take a basis in the receivables equal to the adjusted basis of the liquidating corporation (face less bad debt reserve), because the adjusted basis is the amount paid for the receivables. The buyer should not be able to deduct as an addition to its bad debt reserve the difference between the face amount of the receivables and its basis in the receivables. This amount was already deducted by the liquidating corporation in anticipating its bad debts, and these infirmities are reflected in the amount paid for the receivables. Compare *Citizens' Acceptance Corp. v. United States*, 320 F. Supp. at 801.

124 A long line of cases expresses a policy against double deductions: see, e.g., *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934); *Levi Strauss Realty Co. v. United States*, 41 F.2d 55 (9th Cir.), *cert. denied*, 282 U.S. 868 (1930); *Missouri Pac. R.R. v. United States*, 337 F.2d 637, 640 (Ct. Cl. 1964).

For other analyses of the application of the tax benefit rule to liquidating distributions see Faber, *Sale of a Business*, 37 N.Y.U. INST. FED. TAX. 5-26 to 5-34, 5-59 to 5-67 (1979); Bonovitz, *Problems in Achieving Parity in Tax Treatment under Sections 337 and 334(b)(2)*, 34 N.Y.U. INST. FED. TAX. 57, 67-72 (1976); O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX. L. REV. 215, 233-38 (1972); Note, *The Application of the Tax Benefit Rule to Corporate Distributions of Expensed Assets under I.R.C. § 336*, 29 CASE W. L. REV. 700 (1979).

The impact of the *Tennessee-Carolina* case on liquidations other than those under § 334(b)(2) warrants comment. The case would not have any application in the liquidation of an 80% or greater subsidiary where the basis of the parent is determined under § 334(b)(1), the general basis rule for the liquidation of such subsidiaries. In a § 334(b)(1) liquidation, the basis of the subsidiary in the assets distributed carries over to the parent. Under the *Tennessee-Carolina* facts, the basis of the parent in the expensed asset would be zero. There is no need for restoration of the previously deducted amount to the subsidiary's income. The parent simply steps into the shoes of the subsidiary and there is only one deduction for the cost of the asset, unlike in the case of a § 334(b)(2) liquidation. Section 381(c)(12), in fact, provides that in corporate reorganizations and § 334(b)(1) liquidations, if the acquiring corporation is entitled to the recovery of bad debts or prior taxes or delinquency amounts previously deducted by the transferor corporation, the acquiring corporation shall include in its income such amounts as would have been includable by the transferor in accordance with § 111. Treas. Reg. § 1.381(c)(12)-1(a)(2) (1961) extends this principle generally to "all other losses, expenditures and accruals made the basis of deduction from the gross income of a distributor or transferor corporation for prior taxable years . . ." In view of these provisions, Rev. Rul. 74-396, 1974-2 C.B. 106, 107, explicitly

III. Contributions to Capital and the Tax Benefit Rule

The problems inherent in applying the tax benefit rule to capital contributions are typified by the following illustration. T, an individual, owns fifty percent or less of the stock of X Corporation, and is employed by X as its president. Both T and X are calendar year taxpayers. T's salary in 1979 is \$30,000. During 1979 T lends X \$50,000 at ten percent interest. Because of a cash flow problem, X neither pays salary to T nor interest on T's loan during 1979. As an accrual basis taxpayer, X properly deducts on its 1979 return the salary and interest owed T. As a cash basis taxpayer, T properly does not report any salary or interest in his 1979 return. At the beginning of 1980, T forgives the \$50,000 loan and his \$30,000 1979 salary in order to strengthen X's financial position. X is solvent at all times. The issue is whether X has taxable consequences as a result of T's forgiving the debts, especially in view of X's deduction of accrued interest and salary in the prior year.

First, section 267(a)(2)¹²⁵ would not apply. That section would permanently deny an accrual basis taxpayer any deduction for section 162 expenses or for section 163 interest if (1) the expenses or interest are paid to a cash basis taxpayer related to the accrual basis taxpayer, and (2) the expenses or interest are not paid within two and a half months of the close of the taxable year in which the expenses or interest are due. Under section 267 a shareholder is not deemed "related" to a corporation unless he owns more than fifty percent of the value of the corporation's stock.¹²⁶

Two other general and somewhat overlapping principles may apply to T and X's situation: (1) cancellation of indebtedness income and (2) the tax benefit rule. The leading case involving cancellation of indebtedness income is

held that a subsidiary corporation does not recapture any income on the distribution of an expensed asset in a § 334(b)(1) liquidation. A recapture of income can only occur if the parent corporation subsequently disposes of the expensed asset prior to the end of its useful life.

Likewise, there can be no recapture of any portion of an unused bad debt reserve in a § 334(b)(1) liquidation or corporate reorganization. § 381(c)(4) provides that in such transactions there shall be a carryover of the transferor's accounting method to the acquiring corporation. Under Treas. Reg. § 1.381(c)(4)-1(b)(1) Ex. 1 (1964), the carryover of an accounting method embraces the carryover of the balance of a subsidiary's bad debt reserve. See also *Home Sav. & Loan Ass'n v. United States*, 514 F.2d 1199, 1201 (9th Cir.), cert. denied, 423 U.S. 1015 (1975); *Calavo, Inc. v. Commissioner*, 304 F.2d 650, 652 (9th Cir. 1962); *Citizens Fed. Sav. & Loan Ass'n v. United States*, 290 F.2d 932, 937 (Ct. Cl. 1961); *Home Sav. & Loan Ass'n v. United States*, 223 F. Supp. 134 (S.D. Cal. 1963); *Argus, Inc. v. Commissioner*, 45 T.C. 63, 66-67 (1965).

Such a result is consistent with the recapture rules of §§ 1245 and 1250, which specifically exclude from their coverage transactions in which the basis of the transferee is determined by reference to the basis of the transferor and in which no gain is recognized to the transferor on the transaction. I.R.C. §§ 1245(b)(3) and 1250(d)(3).

The tax benefit rule would apply to distributions in kind in liquidations which, like § 334(b)(2) liquidations, entail a step-up in basis of the distributed asset to the distributee shareholder. These would embrace complete liquidations under § 331(a)(1) in which gain or loss is recognized by the distributee shareholder, as when the shareholders are either individuals or a non-eighty percent corporation. They would also embrace partial liquidations under § 331(a)(2) where realized gain is always recognized by the distributee shareholder whether an eighty percent subsidiary is involved or not. See I.R.C. § 334(a); Rev. Rul. 74-396, 1974-2 C.B. 106, 107.

Presumably the rule would also apply to distributions in an elective, tax-free liquidation under § 333, where the shareholder's basis in the distributed assets is, under § 334(c), his basis in his stock with adjustments for gain recognized to the corporation and for money distributed. Rev. Rul. 74-396, 1974-2 C.B. 106, 107; O'Hare, *supra* note 91, at 203 (1976).

¹²⁵ Section 267(a)(2) is derived from the Revenue Act of 1937, ch. 815, § 301(a), 50 Stat. 827.

¹²⁶ I.R.C. § 267(a)(2)(b)(2).

*United States v. Kirby Lumber Co.*¹²⁷ *Kirby* held that a corporation which repurchases its own bonds at a discount makes a "clear gain" by making available assets previously offset by the obligation of the bonds, and therefore realizes a taxable "accession to income."¹²⁸ *Kirby* thus emphasizes the net increase in the debtor's assets accruing from the cancellation of indebtedness. In the situation of T and X, unless some exception applies, the *Kirby* approach would require X to recognize income not only from the accrued interest and salary but also from the principal of the loan indebtedness.

The tax benefit rule, on the other hand, takes a deduction approach to the problem. If a debt had been previously deducted by the debtor, cancellation of that debt amounts to a recovery and is includable in income to the extent the prior deduction generated a tax benefit to the debtor. Under the tax benefit rule X would be required to include in income the interest and salary, but not the principal of the loan.¹²⁹

Two exclusionary rules come into play along with the two inclusionary rules just discussed: the section 118 exclusion for contributions to capital and the section 102 exclusion for gifts.¹³⁰ These exclusionary rules are among the exceptions to the cancellation of indebtedness income principle.¹³¹ The question of principal concern is whether the tax benefit rule applies in the face of the contribution to capital exclusionary rule. As previously discussed, the exclusionary rules under sections 336 and 337 do not bar application of the tax benefit rule in the corporate liquidation area.¹³² If the tax benefit rule does not apply in the contributions to capital area, the question of whether the shareholder canceling the debt should be taxed under assignment of income principles remains.

Recently in *Putoma Corp. v. Commissioner*, the Fifth Circuit held the tax benefit rule inapplicable to shareholder forgiveness of interest indebtedness previously deducted by the corporation. The decision was based upon the exclusionary rules of sections 102 and 118. Before analyzing *Putoma*, it is necessary to outline the peculiar historical developments that underlie the majority's opinion in that case. The key case is the 1943 Supreme Court decision in *Helvering v. American Dental Co.*¹³³

A. Cases Prior to American Dental

In *Commissioner v. Auto Strop Safety Razor Co.*,¹³⁴ a parent corporation had

¹²⁷ 284 U.S. 1 (1931).

¹²⁸ *Id.* at 3.

¹²⁹ See Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 252-53 (1959); Warren and Sugarman, *Cancellation of Indebtedness and Its Tax Consequences*, 40 COLUM. L. REV. 1326, 1330-51 (1940).

¹³⁰ Section 118 originated with adoption of the Internal Revenue Code of 1954. Pub. L. 591, § 118, 68A Stat. 39. Section 118 merely restated existing law as developed through administrative and court decisions. H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4175.

¹³¹ Besides gifts and contributions to capital, the exceptions to cancellation of indebtedness income include insolvency, reduction of purchase price, and the special exclusionary rule in § 108. For recent outlines of these exceptions, see Note, *A Review of Judicial Exceptions to the Kirby Lumber Rule*, 30 U. FLA. L. REV. 94 (1977); Bitker and Thompson, *Income From the Discharge of Indebtedness: the Progeny of United States v. Kirby Lumber Co.*, 66 CALIF. L. REV. 1159, 1174-87 (1978).

¹³² See text accompanying notes 5-22 *supra*.

¹³³ 318 U.S. 322 (1934).

¹³⁴ 74 F.2d 226 (2nd Cir. 1934), *aff'd* 28 B.T.A. 621 (1933).

forgiven its one hundred percent subsidiary certain indebtedness consisting of royalties, loans and interest. The forgiveness was intended to remove any hindrance to the subsidiary's operations and the marketing of its products.¹³⁵ The court's analysis began with the last sentence in the regulation on cancellation of indebtedness. For the taxable year in question the applicable regulation read as follows:

The cancellation and forgiveness of indebtedness may amount to a payment of income, to a gift, or to a capital transaction, dependent upon the circumstances. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation.¹³⁶

The court accepted the Board's finding that the forgiveness had been gratuitous, and held that the cancellation was a contribution to capital excludable from income under the regulation.¹³⁷

The government had argued that the debtor was on an accrual basis and had deducted the amount of the debt in prior years, whereas the creditor was on a cash basis and had not reported the amount as income.¹³⁸ The Second Circuit held that even if the claimed facts were before it, the result would not change: "In doing what they did these two companies complied with the law. . . . When the indebtedness was cancelled, whether or not it was a contribution to the capital of the debtor depends upon considerations entirely foreign to the question of the payment of income taxes in some previous year."¹³⁹

In 1940 the Eighth Circuit decided *Helvering v. Jane Holding Corp.*¹⁴⁰ In that case a one hundred percent shareholder had placed all his stock in trust for the benefit of his son and his son's family. The trustees then loaned money to the corporation for construction of a building. Interest on the loan was accrued and deducted on the corporation's tax returns, but was not included in the income of the cash basis trustees. Subsequently, to eliminate legal obstacles to a dividend distribution for the ultimate benefit of the trust beneficiaries, the trustees canceled the corporation's indebtedness, including part of the principal and all the accrued interest. The government sought to tax the corporation on the interest that had been forgiven.¹⁴¹

The Board of Tax Appeals held against the government on the authority of *Auto Strop*.¹⁴² Four members dissented in separate opinions. One member relied explicitly on the tax benefit rule.¹⁴³ Another argued that the cancellation

135 28 B.T.A. at 621-22.

136 Treas. Reg. 69, art. 49 (issued pursuant to the Revenue Act of 1926).

137 318 U.S. 322.

138 74 F.2d at 227.

139 *Id.*

140 109 F.2d 933 (8th Cir.), cert. denied, 310 U.S. 653 (1940).

141 109 F.2d at 936.

142 38 B.T.A. 960, 970-71 (1938).

143 *Id.* at 976-78 (Hill, dissenting).

of indebtedness regulation, the same version as was involved in *Auto Strop*, was intended to deal with "principal indebtedness and not accrued interest"¹⁴⁴—an intent indicated by the illustrations contained in the regulation.

The Eighth Circuit reversed the Board of Tax Appeals, holding that the corporation should be taxed because the forgiveness was not without consideration.¹⁴⁵ The consideration was the corporation's release from its legal obligation to discharge its indebtedness and its ensuing freedom to make distributions to the trust beneficiaries.¹⁴⁶ It is difficult to see how any more consideration flowed from the corporation in *Jane Holding* than in *Auto Strop*. Nevertheless, the Eighth Circuit distinguished *Auto Strop* on the ground that in that case the cancellation was gratuitous and its purpose was improvement of the corporation's capital structure.¹⁴⁷

More importantly, the court expressed its agreement with the dissenter below who argued that the cancellation of indebtedness regulation was not intended to cover accrued interest since the regulation referred to "indebtedness" and "debt."¹⁴⁸ The court also held the corporation taxable under the tax benefit rule,¹⁴⁹ stating:

It is only the picture presented by the corporations bookkeeping system that is unreal. That picturing of no income [by way of the deduction for accrued interest], though not unlawful, turns out to be unreal. Brought to an end by the forgiveness and cancellation of the interest debt in 1933, the real income was then made apparent in the return for that year to the tax collector.¹⁵⁰

In the following year the Second Circuit again considered the issue in *Carroll-McCreary Co. v. Commissioner*.¹⁵¹ In that case shareholder-employees forgave a corporation salary indebtedness which the corporation had accrued and deducted in prior years. The shareholders, however, had reported their salaries as income in the years in which the corporation had deducted them. Although this did not cause the distortion that would have resulted if the shareholders had not reported the salaries as income, the court merely mentioned this fact without comment.¹⁵²

The Board of Tax Appeals had found the debt forgiveness non-gratuitous because the shareholders had been benefited by furthering the life of the company. The Second Circuit reversed, holding that an indirect benefit always results to shareholders who make a gift to the corporation. "Gratuitously forgives" simply meant that the corporation paid no consideration for release of the debt.¹⁵³ The court rejected the Commissioner's argument that the cancellation of indebtedness regulation, materially the same as that involved in

¹⁴⁴ *Id.* at 975-76 (Sternhagen, dissenting).

¹⁴⁵ 109 F.2d at 937-38.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at 942. See Warren and Sugarman, *supra* note 116, at 1360-61.

¹⁴⁸ 109 F.2d at 939.

¹⁴⁹ *Id.* at 939-44.

¹⁵⁰ *Id.* at 943.

¹⁵¹ 124 F.2d 303 (2d Cir. 1941).

¹⁵² *Id.* at 304.

¹⁵³ *Id.* at 305.

the preceding cases,¹⁵⁴ did not apply to debts deducted in prior years. Adhering to its decision in *Auto Strop*, the court found nothing in the regulation's language to support the Commissioner's limiting construction.¹⁵⁵ The court distinguished *Jane Holding* on the ground that the cancellation in that case was not gratuitous. The court regarded further comments appearing in *Jane Holding* as mere dicta with which it disagreed.¹⁵⁶

In several unreviewed decisions during 1940 and 1941, involving cancellation of unpaid shareholder salaries deducted by corporations in prior years, the Board of Tax Appeals agreed with *Jane Holding* and held the corporations taxable under the tax benefit rule.¹⁵⁷ In one case the shareholder had reported the salary as income.¹⁵⁸ This fact was not commented on by the Board and had no bearing on its decision.

Thus, prior to the *American Dental* decision in 1943 there were two distinct lines of authority on the question of contributions to capital and the tax benefit rule: one headed by *Auto Strop* and *Carroll-McCreary*, the other by *Jane Holding*. One other noteworthy development was the 1938 amendment to the contributions-to-capital language in the cancellation of indebtedness regulation.¹⁵⁹ The sentence as amended read: "In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to capital of the corporation *to the extent of the principal of the debt*. [Italics indicate language added by amendment.]" This identically worded sentence now appears in Regulation Section 1.61-12(a). The amendment was not in issue in the above cases since they involved taxable years prior to 1938.

B. *The American Dental and George Hall Corp. Cases*

Helvering v. American Dental Co.,¹⁶⁰ decided by the United States Supreme Court in 1943, involved a forgiveness of corporate indebtedness by outside creditors rather than shareholders. The amounts owed were interest and rent which the corporation had accrued and deducted in prior years.¹⁶¹ The Board of Tax Appeals rejected the corporation's contention that the cancellation was

¹⁵⁴ Treas. Reg. 86, art. 22(a)-14 (issued pursuant to the Revenue Act of 1934), quoted in 124 F.2d at 304 n.1. Although there were a number of changes in this regulation, the sentence pertaining to contributions to capital remained the same. *Id.* at 305 n.1.

¹⁵⁵ 124 F.2d at 305.

¹⁵⁶ *Id.*

¹⁵⁷ *Howard Paper Co. v. Commissioner*, 43 B.T.A. 545 (1941); *Amsco-Wire Products Corp. v. Commissioner*, 44 B.T.A. 717 (1941); *Beacon Auto Stores, Inc. v. Commissioner*, 42 B.T.A. 703 (1940). In *Beacon Auto Stores*, the Board also appeared to be of the opinion that under the facts the forgiveness did not amount to a contribution to capital. 42 B.T.A. at 705.

¹⁵⁸ *Amsco-Wire Products Corp. v. Commissioner*, 43 B.T.A. 545 (1941). In *Beacon Auto Stores v. Commissioner*, 42 B.T.A. 703 (1940), the shareholders did not always report the unpaid salary. The Board simply commented: "The petitioner fails to make anything of importance out of the inconsistency of the individuals in reporting or failing to report the full amount credited to them." 42 B.T.A. at 705.

In *In re Triple Z Products, Inc.*, 27 A.F.T.R. 1164, 1165 (S.D.N.Y. 1940), the district court followed *Auto Strop Safety Razor* because it was the binding authority in its circuit. In *Triple Z*, the shareholders did report as income the salaries deducted by the corporation. Nevertheless, this fact had no apparent bearing on the court's decision.

¹⁵⁹ Treas. Reg. 101, art. 22(a)-14 (issued pursuant to the Revenue Act of 1938). See *Midland Tailors*, 2 [1943] T.C.M. (CCH) 281, 284.

¹⁶⁰ 318 U.S. 322 (1943).

¹⁶¹ *Id.* at 323-24. The facts do not indicate whether the creditors had reported the interest or rent as income.

an excludable gift stating: "No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity."¹⁶² The Board held that the cancellation was income under the tax benefit principle.¹⁶³

The Seventh Circuit reversed, holding the cancellation excludable as a gift because it lacked consideration and inured solely to the corporation's benefit.¹⁶⁴ The Supreme Court affirmed the Seventh Circuit holding in these words: "The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute."¹⁶⁵ The failure of the Court to discuss the tax benefit rule and its focus on whether or not there was a gift was probably due to the government's conceding that if the forgiveness were truly a gift it would be excludable from income.¹⁶⁶

In passing, however, the Court did comment on contributions to capital: "Where a stockholder gratuitously forgives the corporation's debt to himself, the transaction has long been recognized by the Treasury as a contribution to the capital of the corporation."¹⁶⁷ The Court cited *Auto Strop* and the pre-1938 version of the cancellation of indebtedness regulation. Since the taxable year involved in *American Dental* was 1937, the Court did not mention the 1938 amendment to the contributions-to-capital language in that regulation.¹⁶⁸

Later in 1943, the full Tax Court considered the impact of *American Dental* on a situation involving the forgiveness of interest owed a shareholder-debenture holder which was deducted by the corporation in prior years. In *George Hall Corp.*,¹⁶⁹ the shareholder had not included the interest in his income during the prior years. The debt was canceled to strengthen the corporation's financial position.¹⁷⁰

In an earlier, superseded Tax Court decision on the same case, the majority had held the cancellation of interest to be income to the corporation. The short opinion¹⁷¹ made oblique references to *Jane Holding* and *United States v. Kirby Lumber Co.*¹⁷² The four judge concurring opinion in the superseded decision is of interest because of its reference to the 1938 amendment to the

162 44 B.T.A. 425, 428 (1941).

163 *Id.* at 428-29.

164 128 F.2d 254 (7th Cir. 1942).

165 318 U.S. at 331.

166 See summary of government's brief in *Helvering v. American Dental Co.*, 87 L. Ed. 785, 786-87 (1943); *Putoma Corp. v. Commissioner*, 601 F.2d 734, 752 (5th Cir. 1979) (Rubin, J. dissenting); *American Dental Co. v. Commissioner*, 128 F.2d 254, 255 (7th Cir. 1942); *Putoma Corp. v. Commissioner*, 66 T.C. 652, 667 n.16 (1976).

167 318 U.S. at 328.

168 See text accompanying note 141 *supra*. The Court quoted the following language in the cancellation of indebtedness regulation: "If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income." *Id.* at 326.

This sentence, however, was deleted from the regulation in 1934, and was not in effect for the taxable year in question, 1937. The 1932 and 1936 versions of the regulation are quoted in full by the court. *Id.* at 326-27 nn. 4 & 5.

169 2 T.C. 146 (1943).

170 This decision superseded an earlier opinion in the same case, also reviewed by the full court. 1 T.C. 471 (1943).

171 *Id.* at 472-73.

172 284 U.S. 1 (1931).

contributions-to-capital language in the cancellation of indebtedness regulation.¹⁷³ The concurring opinion regarded the amendment as "simply a clarification of what had been the meaning of the language all along."¹⁷⁴

In the superseding decision, the majority held that *American Dental* required the conclusion that cancellation of the interest indebtedness was a non-taxable gift despite the deduction of the indebtedness in earlier years.¹⁷⁵ The majority considered irrelevant the fact that the regulation also called the transaction a contribution to capital.¹⁷⁶ Two dissenting judges declared: "The decision here, I think, should follow that in *Helvering v. Jane Holding Corp.* The holding of the Supreme Court in *Commissioner v. American Dental Co.* must be 'read in the context of its facts.' When so read it certainly is not to be construed as reversing *Helvering v. Jane Holding Corp.* . . ."¹⁷⁷

C. *The Jacobson Case and Subsequent Contribution to Capital Cases*

In 1949, the Supreme Court impliedly overruled its position in *American Dental* as to the meaning of a gift. In *Commissioner v. Jacobson*,¹⁷⁸ an individual taxpayer in straitened financial circumstances purchased at less than face value negotiable bonds which he had originally issued at face value for cash. All the sellers of the bonds knew the bonds were being purchased by or on behalf of the maker. Unless the transaction was a gift, the difference between the face value and the amount paid for repurchase would be income to the taxpayer under *United States v. Kirby Lumber Co.*¹⁷⁹ The Supreme Court held that the transaction was not a gift because there was no evidence the sellers were not acting in their own interest by attempting to obtain the best available price for their claims.¹⁸⁰ The Court stated: "The situation in each transaction is a factual one. It turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance 'for nothing.'"¹⁸¹

Because the Supreme Court reverted to a motive test in *Jacobson*, *American Dental*'s meaning of gift was no longer viable.¹⁸² Nevertheless, *American Dental* continued to be influential because it had found an excludable gift in a situation involving the forgiveness of interest and rent deducted by a taxpayer in

173 See text accompanying note 141 *supra*.

174 1 T.C. at 474. The pre-1938 version of the regulation was effective for the taxable years in question in the case.

175 2 T.C. 146 (1943).

176 *Id.* at 147.

177 *Id.* (citations omitted). For holdings in 1943 and 1944 similar to the superseding decision in *George Hall Corp.*, see *Pondfield Realty Co. v. Commissioner*, 1943 FED. TAXES (P-H) ¶ 61,103 (2d Cir. 1943), *rev'g without opinion* 1 T.C. 217 (1942); *Pancoast Hotel Co. v. Commissioner*, 2 T.C. 362 (1943); *McConway & Torley Corp. v. Commissioner*, 2 T.C. 593 (1943); *S. H. DeRoy & Co.*, [1944] T.C.M. (P-H) ¶ 44,154; *Brown Cab Co.*, [1943] T.C.M. (P-H) ¶ 43,262, *superseding* [1943] T.C.M. (P-H) ¶ 43,033; *Midland Tailors*, [1943] T.C.M. (P-H) ¶ 43,292; *Tanner Manufacturing Co.*, [1943] T.C.M. (P-H) ¶ 43,299.

178 336 U.S. 28 (1949).

179 284 U.S. 1 (1931).

180 336 U.S. at 50-52.

181 *Id.* at 51. The Supreme Court distinguished *American Dental* by stating that a gift was more likely to occur in connection with a release of an open account for rent or for interest than with a sale of outstanding securities. *Id.* See the later Supreme Court decision of *Commissioner v. Duberstein*, 363 U.S. 278 (1960), where the Court further elaborated on the necessity of donative intent in a gift transaction.

182 See Eustice, *supra* note 129, at 248-50; Bittker and Thompson, *supra* note 131, at 1178.

prior years. Thus, in *Reynolds v. Boos*¹⁸³ an individual taxpayer was forgiven unpaid rent which he had accrued and deducted in prior years. After affirming the district court's finding of a gift,¹⁸⁴ the Eighth Circuit rejected the government's contention that, gift or no gift, the cancellation of rent was includable under the tax benefit rule.¹⁸⁵ The court pointed out that although the taxpayers in *American Dental* had received prior tax benefits, the Supreme Court had found an excludable gift.¹⁸⁶

In *Utilities & Industries Corp.*,¹⁸⁷ a corporate shareholder had canceled unpaid interest on a loan to the corporation's subsidiary. The subsidiary had accrued and deducted this interest in prior years, but the parent had also included the interest in those years as an accrual basis taxpayer. The cancellation had occurred when the corporation was undergoing a bankruptcy reorganization. In an unreviewed decision, the Tax Court held that the cancellation was an excludable contribution to capital.¹⁸⁸ The court stated that this exclusion had been held applicable both to principal and accrued interest regardless of prior years' tax treatment of such interest, citing *Auto Strop* and other cases. The Tax Court also held the cancellation excludable under the exception in the regulations for bankruptcy reorganizations.¹⁸⁹

In *Commissioner v. Fender Sales*,¹⁹⁰ the Ninth Circuit considered a situation in which both fifty percent shareholders had canceled unpaid salaries owed them by the corporation in order to facilitate a bank loan. The corporation had deducted these salaries in prior years and the shareholders had not included them in income. In addition, the corporation had issued the two shareholders equal additional shares of common stock in return for the cancellation. Thus, after the transaction each shareholder continued to own fifty percent of the corporation's common stock.

The Ninth Circuit focused on the potential tax liability of the shareholders arising from their receipt of the stock. The court held the stock's fair market value taxable to the shareholders since the stock had been issued in discharge of the corporation's salary obligations to them.¹⁹¹ The court considered immaterial the fact that the shareholders' percentage interest in the corporation had remained unchanged. As would not be the case in a *pro rata* stock dividend, the corporation was substantially different after the transaction, since its net worth increased due to the cancellation of the salaries. This increase in the corporation's net worth substantially enhanced the value of the stockholders' holdings in the corporation.¹⁹²

183 188 F.2d 322 (8th Cir. 1951), *aff'd* 84 F. Supp. 185 (D. Minn. 1949).

184 The aberrational quality of this case on the gift question was noted in *Bradford v. Commissioner*, 233 F.2d 935, 937 (6th Cir. 1956).

185 188 F.2d at 325-26.

186 *Id.* at 326. The district court similarly rejected the government's argument. 84 F. Supp. at 188-89. Note that the Eighth Circuit decided the 1940 case of *Jane Holding Corp.*

187 41 T.C. 888 (1964), *rev'd on other grounds sub nom.* *South Bay Corp. v. Commissioner*, 345 F.2d 698 (2d Cir. 1965).

188 41 T.C. at 910.

189 *Id.* The applicable regulation was Treas. Reg. 111 § 29.22(a)-13(b)(1) (1944), now Treas. Reg. 1.61-12(b)(1) (1960). The regulation expresses the insolvency exception to cancellation of indebtedness income.

190 338 F.2d 924 (9th Cir. 1965), *rev'g in part* [1963] T.C.M. (P-H) ¶ 63,119, *cert. denied*, 381 U.S. 935, 382 U.S. 813 (1965) (separate denials for consolidated cases).

191 *Id.* at 927.

192 *Id.*

The *Fender Sales* court relied on *Helvering v. Horst*,¹⁹³ in which the Supreme Court held that income received on payment of interest from coupon bonds and given by a father to his son as a gift was taxable to the father.¹⁹⁴ The Ninth Circuit stated:

Randall and Fender, when they voluntarily elected to exercise their dominion and control over the choses in action against Fender Sales, Inc. for unpaid salaries by extinguishing them for the benefit of the corporation, of which they were sole owners, thereby augmenting the intrinsic worth of the capital stock they held, more surely "realized" for their own benefit the value of the obligations discharged than did Horst in his gift of interest coupons to his son.¹⁹⁵

Finally, the court summarily rejected the government's alternative argument that the corporation rather than the shareholders should be taxed.¹⁹⁶ The court found the transaction to be either a payment for stock, excludable under section 1032, or a contribution to capital, excludable under section 118. The court cited as authority *Carroll-McCreary*, *Auto Strop* and *American Dental*.

Judge Barnes dissented solely on the question of the taxability of the shareholders.¹⁹⁷ According to the judge, this was the first case he had encountered in which shareholders had been found to have realized income on an increase in corporate net worth where neither a dividend had been declared nor a capital gain realized by the shareholders.¹⁹⁸ The judge likened the *Fender Sales* facts to a situation in which shareholders initially forgo taking a salary for services to the corporation.¹⁹⁹ In such an event the shareholders would not be currently taxed, but would simply have enhanced the value of their investment in the corporation. This enhancement would be taxed at a capital gain rate when the stockholders later disposed of their stock.²⁰⁰

Finally, in *Hartland Associates*,²⁰¹ a one hundred percent shareholder had purchased certain promissory notes with accrued interest outstanding against his corporation. The corporation had deducted the interest in prior years but it is unclear whether the prior noteholders included the interest in income. The shareholder canceled the corporation's accrued interest to improve the corporation's deteriorating financial condition. In an unreviewed decision, the Tax Court held the cancellation to be a gratuitous contribution to capital, excludable from the corporation's income. Citing *Auto Strop* and *American Dental*,

193 311 U.S. 112 (1940).

194 338 F.2d at 928-29.

195 *Id.* at 929.

196 *Id.* at 930. The Service expressed agreement with *Fender Sales* on the issue of the taxability of the shareholders in Rev. Rul. 67-402, 1967-2 C.B. 135. For cases to the contrary, see *Joy Mfg. v. Commissioner*, 230 F.2d 740 (3d Cir. 1956); *Delos E. Daggitt v. Commissioner*, 23 T.C. 31 (1954).

197 338 F. 2d at 930 (Barnes, J. dissenting in part and concurring in part).

198 *Id.*

199 *Id.* at 931. Judge Barnes concurred on the question of the taxability of the corporation. While recognizing that *American Dental* did not precisely govern the situation involved in *Fender Sales*, Judge Barnes noted that the trend after *American Dental* was to follow *Carroll-McCreary* and not *Jane Holding*. The latter cases had held that the prior deduction of a debt was immaterial as to whether a nontaxable contribution to capital was effected by the debt cancellation. *Id.* at 933.

200 *Id.* at 931.

201 54 T.C. 1580 (1970).

the court stated that the corporation's deduction of the interest in prior years was immaterial.²⁰²

D. *The Putoma Case*

In *Putoma Corp. v. Commissioner*,²⁰³ a fifty percent shareholder in two corporations forgave interest owed him by the corporation in order to improve the corporation's financial condition in the eyes of creditors and potential lenders. The corporation had accrued and deducted the unpaid interest, but as a cash basis taxpayer, the shareholder had not included the interest in the income.

In a reviewed decision, the Tax Court rejected the Commissioner's argument that the transaction resulted in income to the corporation.²⁰⁴ The court noted that the problem presented by the facts arose from the convergence of a rule of income exclusion (gratuitous contributions to capital) and two rules of income inclusion (cancellation of indebtedness income and the tax benefit rule). The contribution to capital exclusionary rule clearly overrides the cancellation of indebtedness income principal when a shareholder gratuitously forgives a debt owed him by his corporation. It does not follow, however, that when the canceled indebtedness consists of interest accrued and deducted by the corporation the tax benefit rule should automatically disappear with the cancellation of indebtedness income principle. The majority stated that the two inclusionary rules in fact vanished together "[d]ue more to history than logic."²⁰⁵ Prior to *American Dental* the Commissioner had argued, with mixed results,²⁰⁶ that the contribution to capital expulsion did not extend to the cancellation of previously deducted items resulting in a tax benefit. *American Dental* proved a "mortal blow" to the Commissioner's theory, however.²⁰⁷ *American Dental* was relied on in a series of cases holding that the cancellation of accrued and deducted items does not produce income to the debtor if the cancellation is a contribution to capital. The Tax Court concluded that "[w]hile a theoretically correct statement might indeed have merit considered de novo, we hardly write on a clean slate."²⁰⁸

The Tax Court also rejected the Commissioner's alternative argument, based on *Fender Sales*²⁰⁹ and *Helvering v. Horst*, that the shareholder should be taxed on the cancellation. *Fender Sales* was distinguished because stock was received in that case in consideration of the cancellation.²¹⁰ Because the financial problems of Putoma made collectability of the interest obligation doubtful,

²⁰² *Id.* at 1586. Another issue in the case involved the application of § 267(a)(2) to certain rental expenses. *Id.* at 1587-90.

²⁰³ See also *Greer v. Commissioner*, 230 F.2d 490 (5th Cir. 1956), *rev'g* *Brazoria Inv. Corp. v. Commissioner*, 20 T.C. 690 (1953); *Leo Perlman v. Commissioner*, 27 T.C. 755, 757 (1957), *aff'd*, 252 F.2d 890 (2d Cir. 1958); Rev. Rul. 76-316, 1976-2 C.B. 22.

²⁰⁴ 601 F.2d 734 (5th Cir. 1979), *aff'g* 66 T.C. 652 (1976).

²⁰⁵ 66 T.C. at 663-68.

²⁰⁶ *Id.* at 663, 666.

²⁰⁷ *Id.* at 666.

²⁰⁸ *Id.*

²⁰⁹ *Id.* at 668. In a footnote, the majority noted the anomaly inherent in the Commissioner's regulations and rulings holding that the insolvency exception to cancellation of indebtedness income applied even when the debtor has received a tax benefit through the deduction of the cancelled indebtedness. *Id.* at 668 n.20. See also *Eustice*, *supra* note 129, at 253.

²¹⁰ Discussed in text accompanying notes 173-77 *supra*.

²¹¹ 66 T.C. at 669.

the Tax Court was unable to find that the shareholder exercised a power to dispose of income equivalent to realization.²¹¹ The court stated:

As a practical matter, the options open to petitioners did not really include a power of disposal, but were limited to relinquishment or maintaining the status quo. Any 'dominion and control' was of a very tenuous nature, and exercisable only within this narrow corridor. The course of action followed arose from and was circumscribed by the existing exigencies, and we decline to equate this 'dominion and control' with the assignment of a receivable by an individual either to secure a reciprocal advantage—discharge of a debt, the supply of goods, the rendering of services, etc.—or to make a gift.²¹²

The Fifth Circuit affirmed the Tax Court,²¹³ holding that the corporation had no income despite its receiving a tax benefit through a deduction for the cancelled interest indebtedness. Oddly, the court held that the transaction was excludable not only as a contribution to capital under section 118 but also as a gift under section 102.²¹⁴ The court appears to have been wrong in this regard: a transaction cannot be both a contribution to capital and a gift. A contribution to capital involves an intent to enhance the value of one's own stock investment. A gift involves donative intent, such as would exist where the dominant motive of a contribution to the capital of a family corporation is to benefit shareholder-relatives.²¹⁵

The three judge dissent in the Tax Court stressed the overriding accounting role of the tax benefit rule, pointing to the cases holding the rule applicable in the face of section 337's exclusionary rule.²¹⁶ In his dissent from the Fifth Circuit's majority opinion, Judge Rubin observed that the 1938 amendment to the cancellation of indebtedness regulation made clear that the contribution to capital exclusion did not extend to the interest portion of a canceled corporate debt to the extent of a prior tax benefit to the corporation.²¹⁷ The amendment had little influence on the course of judicial decision because the *American Dental* case appeared to be contrary precedent.²¹⁸ However, not only did *American Dental* concern gifts rather than contributions to capital, but the Commissioner had also conceded in that case that the cancellation would be excludable from corporate income if it were a gift. Judge Rubin agreed that gifts to corporations were nontaxable under section 102 to the full extent of principal and interest, and that the regulations defining a "gift" did not compel a different conclu-

211 66 T.C. at 670.

212 *Id.* The majority opinion noted that, under the logic of the government's theory, in cancelling interest indebtedness a creditor would recognize income even if the debtor as a cash basis taxpayer had not deducted the interest. *Id.* at 671, n.29.

213 601 F.2d 734 (5th Cir. 1979).

214 *Id.* at 742, 751.

215 See *Pennsylvania Electric Co. v. United States*, 135 F. Supp. 416, 418 (Ct. Cl. 1955); Behrsin, *What Constitutes Contribution to Capital Is Still Unclear—Can It Be Treated as a Gift?*, 44 J. TAX. 270, 274-75 (1976); Landis, *Contributions to Capital of Corporations*, 24 TAX L. REV. 241, 246 (1969); Warren and Sugarman, *supra* note 129, at 1366-67; Comment, 14 GA. L. REV. 126, 132-33 (1979).

In the Tax Court, the Commissioner apparently abandoned his alternative argument that the shareholder should be taxed under *Fender Sales*.

216 66 T.C. at 675-78.

217 601 F.2d at 752-54. See text accompanying note 159 *supra*.

218 *Id.* at 753-54. A similar analysis of *American Dental* is found in Judge Simpson's Tax Court dissent. 66 T.C. at 678.

sion.²¹⁹ *Putoma* involved not a gift but a contribution to capital and, under the regulations, the exclusion for contributions to capital extends to cancellation only of the principal of a debt.²²⁰

E. Analysis of *Putoma*

Putoma presented a classic case for application of the tax benefit rule. A corporation deducted unpaid but accrued interest on a debt owed a shareholder and thereby achieved a reduction in its taxes. The shareholder did not include the interest in income. He subsequently released the corporation from its liability for the accrued interest, increasing the corporation's net worth to the extent of the liability. This constitutes a "recovery" of the deduction in a very common form.²²¹

If the shareholder had included the interest in income at some point (for example, at the time it was due under accrual basis accounting), the tax benefit rule should not apply. The inclusion would be essentially the same as if the corporation had actually paid the interest and the shareholder had then contributed the interest proceeds to the corporation's capital, a clearly excludable transaction under section 118.²²²

The nonrecognition rule of section 118 should no more bar application of the tax benefit rule than should the nonrecognition rules of sections 336 and 337.²²³ The tax benefit rule is an overriding accounting principle which prevents the distortion resulting from a taxpayers' taking a deduction which, in the light of subsequent events, turns out to have been unwarranted.

The tax benefit rule was rejected in *Putoma* not on its merits but because of history. The key obstacle to application of the rule was the *American Dental* decision. Although the Fifth Circuit dissent in *Putoma* distinguished *American Dental* in part because it involved a gift rather than a contribution to capital,²²⁴ it is difficult to perceive why the rule should apply in one case and not the other. The important fact about *American Dental* is that the Supreme Court concerned itself solely with whether there was a gift (as determined under guidelines later overturned in *Jacobson*)²²⁵ and did not deal with the applicability of the tax benefit rule. This likely resulted from the government's concession that if the transaction were truly a gift it would be excludable from income.²²⁶ There is strong case precedent in *Jane Holding*²²⁷ (as well as a long standing regulation²²⁸) favoring application of the tax benefit rule. That precedent should not be nullified by misapprehensions about the impact of *American Dental*. As the

219 601 F.2d at 753. Judge Simpson's dissenting opinion in the Tax Court appears to be to the contrary on this point. 66 T.C. at 677-78.

220 601 F.2d at 753-54. The Tax Court decision in *Putoma Corp.* was followed in *Dwyer v. United States*, 439 F. Supp. 99 (D. Or. 1977).

221 See note 94 *supra* and accompanying text.

222 O'Hare, *supra* note 123, at 243. However, Rev. Rul. 76-316, 1976-2 C.B. 22, is to the contrary.

223 See text accompanying note 121 *supra*.

224 See text accompanying note 219 *supra*.

225 See text accompanying notes 178-86 *supra*.

226 See text accompanying note 166 *supra*.

227 Discussed in text accompanying notes 140-50 *supra*. The 1951 decision of the Eighth Circuit in *Reynolds v. Boos*, discussed in text accompanying notes 166-68 *supra*, tends to contradict *Jane Holding*. However, *Reynolds v. Boos* was a gift situation, and no mention was made of *Jane Holding*.

228 See text accompanying note 159 *supra*.

Putoma Tax Court dissent stated, an attempt should be made "to clarify this area of the law and not add to its confusion" ²²⁹

It is possible to tax shareholders under the *Helvering v. Horst* principle²³⁰ in lieu of taxing the corporation under the tax benefit rule. In theory, by electing to cancel interest or salary indebtedness to strengthen his company's financial condition, a shareholder has exercised sufficient dominion over the interest or salary to have realized income for tax purposes. This approach was embraced by the Ninth Circuit in *Fender Sales*²³¹ and was rejected, at least under the facts of the case, by the Tax Court in *Putoma*.²³² It is open to serious question whether the *Helvering v. Horst* principle can encompass such a shareholder transaction. In essence, what the shareholder has done is convert a creditor's claim (which may be of tenuous value against a financially straitened corporation) into a capital interest. Income will not be realized from this capital interest until the interest is sold or the corporation pays a dividend.²³³ A situation involving such a contribution to the corporation's capital is equivalent to the situation in which the shareholder grants the corporation an interest-free loan or forgoes drawing a salary because the shareholder would presently realize no income under either circumstance.

It would seem preferable to use the tax benefit rule to tax the corporation on the prior deduction of interest or salary which the corporation subsequently does not have to pay. In that way, the corporation's tax liability will be equivalent to what it would have been had no salary or interest obligation been established initially.²³⁴

IV. Conclusion

Given the overriding accounting role of the tax benefit rule, the *Tennessee-Carolina Transportation* case correctly applied the rule to liquidating distributions of expensed assets. An "inconsistent event" analysis would seem to be the best rationale for this application of the doctrine. On the other hand, the failure of *Putoma* to apply the tax benefit rule to contributions to capital by way of forgiveness of interest and expense indebtedness compares unfavorably with the properly expansive application of the rule in the corporate liquidation area. The basis for refusing to apply the rule in the contribution to capital area is an unwarranted reliance on *American Dental*. Taxation of the corporation under the tax benefit rule would seem a better approach to rectifying such income distortion than taxing the shareholder under assignment of income principles. To tax neither the shareholder nor the corporation leads to a totally unwarranted tax windfall.

²²⁹ 66 T.C. at 679.

²³⁰ See text accompanying notes 193-95 *supra*.

²³¹ Discussed in text accompanying notes 191-196 *supra*. *Fender Sales* involved a cancellation of salary indebtedness in return for a pro rata issuance of stock. The approach taken in the case would also logically apply to a contribution to capital situation.

²³² Discussed in text accompanying notes 209-12 *supra*.

²³³ See Comment, 17 HASTINGS L.J. 784, 789-90 (1966).

²³⁴ For commentaries in favor of the application of the tax benefit rule, see Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153, 1176-77 (1940); Warren and Sugarman, *supra* note 129 at 1348-49, 1358-59; Comment, 17 HASTINGS L.J. 784, 788-91 (1966); Comment, 13 U.C.L.A. L. REV. 833, 847-55 (1966); Comment, 32 U. MIAMI L. REV. 487 (1977). One commentator suggests a possible § 482 approach to the problem. Note, 30 FLA. L. REV. 94, 106-07 (1977).

One recent commentary argues in favor of taxing the shareholder under a constructive receipt of income theory and argues against the taxation of the corporation under the tax benefit rule. Bittker and Thompson, *supra* note 131, at 1179-82.